S. Hrg. 101-868, Vol. I

THE ABUSE AND MISMANAGEMENT OF HUD

HEARINGS

BEFORE THE

HUD/MOD REHAB INVESTIGATION
SUBCOMMITTEE

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

VOLUME I OF II

JANUARY 30, 1990—THE MISSION OF HUD

FEBRUARY 27, 1990—THE ANATOMY OF A DEAL

MARCH 27, 1990—COINSURANCE

APRIL 18, 1990—PAST AND PRESENT HUD MANAGEMENT

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE
28-956 WASHINGTON : 1990

S241-55

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

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CONTENTS

VOLUME I OF II

TUESDAY, JANUARY 30, 1990

THE MISSION OF HUD

Page
Opening statement of Senator Graham ... 1
Prepared statement ... 2
Opening statement of Senator Riegle ... 2
Prepared statement ... 3
Prepared statement of Senator Mack ... 4
Prepared statement of Senator Shelby ... 5

WITNESSES

Robert Weaver, former Secretary, Department of Housing and Urban Development, professor emeritus of urban affairs, Hunter College, City University of New York; and Robert Wood, former Secretary, Department of Housing and Urban Development, the Henry R. Luce, professor of democratic institutions and the social order, Wesleyan University, Middletown, CT ... 6
Prepared statement ... 8
Richard Van Dusen, former Under Secretary, Department of Housing and Urban Development, chairman, Dickinson, Wright, Moon, Van Dusen & Freeman, Detroit, MI ... 21
Prepared statement ... 23
John Rhinelander, former Under Secretary, Department of Housing and Urban Development, partner, Shaw, Pittman, Potts & Trowbridge, Washington, DC ... 25
Prepared statement ... 27
Philip Brownstein, former Federal housing commissioner, senior partner, Brownstein, Zeidman and Schomer, Washington, DC ... 33
Prepared statement ... 35
Anthony Downs, senior fellow in economics, The Brookings Institute, Washington, DC ... 52
Prepared statement ... 55
Rudolph Penner, senior fellow, The Urban Institute, Washington, DC ... 66
Prepared statement ... 68

TUESDAY, FEBRUARY 27, 1990

THE ANATOMY OF A DEAL

Opening statement of Senator Graham ... 87
Prepared statement ... 88
Opening statements of:
Senator Mack ... 88
Senator Bryan ... 98

Page

WITNESSES

Richard Baron, president, McCormack Baron and Associates, St. Louis, MO 88
Thomas P. Costello, senior vice president, property management, MBA Realty, St. Louis, MO 97
Philip Abrams, Philips Development, Engelwood, CO 115
Joseph M. Queenan, J. Michael Queenan Associates, Inc., Denver, CO 116
Tom Coe, vice president, Benton Mortgage Co., Knoxville, TN 116
William Tanker, vice president of underwriting, Benton Mortgage Co., Knoxville, TN 118
    Prepared statements [Joint] 119
    Response to written questions of Senator Riegle 282
William Cottrell, executive director, Clark County Housing Authority, Clark County, Las Vegas, NV 137
    Prepared statement 141
    Letters related to testimony:
        March 9, 1990 175
        June 1, 1990 176
John Ols, Director of Economic and Community Development Issues, U.S. General Accounting Office, Washington, DC 146
    Prepared statement 150

AFTERNOON SESSION

Marilyn Melkonian, president, Telesis Corp., Washington, DC 185
    Prepared statement 189
Karen Kollias, vice president of community development lending group, American Security Bank, Washington, DC 201
    Prepared statement 204
Sheldon Baskin, attorney, Chicago, IL 221
    Prepared statement 223
Patrick E. Clancy, executive director, The Community Builders, Boston, MA 245
    Prepared statement 250

TUESDAY, MARCH 27, 1990

COINSURANCE

Opening statement of Senator Graham 333
Opening remarks of Senator Mack 335
    Complete prepared statement of Senator Mack 336

WITNESSES

George Hipps, Senior Vice President, PW Funding, Inc., Washington, DC 338
    Prepared statement 465
Gaye G. Beasley, Member, Board of Governors, Mortgage Bankers Association, Washington, DC 339
    Prepared statement 480
Larry Dale, Senior Vice President, Multifamily Finance and Housing Initiatives, Federal National Mortgage Association, Washington, DC 341
    Prepared statement 498
Warren Lasko, Executive Vice President, Mortgage Bankers Association, Washington, DC 342
    Prepared statement 512
Peter H. Monroe, General Deputy Assistant Secretary of Housing, Department of Housing and Urban Development, Deputy Federal Housing Commissioner, Washington, DC 347
    Prepared statement 518
Alfred DelliBovi, Under Secretary, Department of Housing and Urban Development, Washington, DC 345
    Prepared statement 538
Professor Robert Edelstein, Center for Real Estate and Urban Economics, University of California at Berkeley, Berkeley, CA 348
    Prepared statement 546
Thomas Craren, Partner, Price Waterhouse, Washington, DC 433
    Prepared statement 557
Chris Greer, Assistant Inspector General for Audit, Department of Housing and Urban Development, Washington, DC 437
    Prepared statement 563

Page
Robert P. Kalish, Executive Vice President, Government National Mortgage Association, Washington, DC 451
John Baecker, Former President and Chief Underwriter, United Guaranty Commercial Insurance Company, Greensboro, NC 581

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Mortgage Bankers Association of America:
  Recommendations on bankruptcy law reform 591
  Letter from Senator Graham to Gaye Beasley and Warren Lasko dated April 12, 1990 596
  Response to letter from Senator Graham 598
  Charts:
    Chart A.—Defaulted Coinsured Loans 600
    Chart B.—Section 223(f) 601
    Chart C.—Section 221(d) 602
    Chart D.—Illustration of how FHA's multifamily coinsurance and GNMA's MBS programs work together 603
    Chart E.—Compliance with coinsurance program requirements 604
    Table 2.—Coinsurance defaults and claims as of August 31, 1989 605
    Concentration of risk among the largest coinsurers 606

WEDNESDAY, APRIL 18, 1990

PAST AND PRESENT HUD MANAGEMENT: MATERIAL WEAKNESSES

Opening statement of Senator Graham 607
Opening statement of Senator Mack 609

WITNESSES

Paul Adams, Inspector General, Department of Housing and Urban Development, Washington, DC; accompanied by Chris Greer, assistant inspector general for audit, HUD; and James Martin, director of planning and administration, Office of Audit, HUD 609
  Prepared statement 612
    Internal management controls 614
    Financial management systems 615
    Summary 616
      Summary of results, 1983 617
      Summary of results, 1984 619
      Summary, 1985 622
      Executive summary, 1986 623
      Executive summary, 1987 624
      Executive summary, 1988 626
Alfred DelliBovi, Under Secretary, Department of Housing and Urban Development; accompanied by Harold Henry, director, Office of Management and Quality Assurance, HUD; Janice Combs, director, Financial Management Systems, Office of Finance and Accounting, HUD 639
  Prepared statement 642
    Introduction 642
    General financial management improvements 642
    Specific improvements made in internal controls program 644
    Conclusion 648
Donald Chapin, Assistant Comptroller, Accounting and Financial Management Division, U.S. General Accounting Office; accompanied by Jeffrey Steinhoff, Director, Financial Management Issues and Audits, GAO; and John Ols, Jr., Director, Housing and Community Development Issues, GAO. 663
  Prepared statement 667
    Weak internal control systems exist throughout the Government 669
    Financial management systems are weak and improvements are slow, costly, and often ineffective 671
    A strong work force is needed to meet current and future challenges.. 672
    Actions needed to strengthen controls and accounting systems 673
    GAO's "High Risk" program 682
    GAO testimony of Dennis J. Duquette, dated September 13, 1989 687

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Page

Chart A.—HUD's most serious existing material weaknesses, 1989 FMFIA Report 712

Chart B.—How HUD compiles its annual FMFI reports 715

Letter dated December 31, 1987, to the White House, from Samuel R. Pierce, Jr 716

Letter dated December 29, 1989, to the White House, from Jack Kemp [Without enclosures] 720

U.S. Senate HUD Mod Rehab Investigation, April 8, 1990, hearing response from Watson Rice and Co., CPA's 733

VOLUME II OF II

FRIDAY, APRIL 20, 1990

STAFFING AND ORGANIZATIONAL CAPACITY

Opening statement of Senator Graham 1
Opening statement of Senator Mack 2

WITNESSES

George O. Hipps, vice president, P.W. Funding Mortgage Co., Washington, DC 3
  Prepared statement 5
Alfred Kliman, Director, Office of Budget, Department of Housing and Urban Development 13
Walter Sevier, Deputy Regional Administrator, Fort Worth Regional Office, Department of Housing and Urban Development, Fort Worth, TX 13
Marvin Siflinger, executive director, Massachusetts State Housing Finance Agency, Boston, MA, on behalf of National Council of State Housing Finance Agencies 28
Daniel, Grady, president, The Monfric Corp., San Diego, CA, on behalf of National Assisted Housing Management Association 30
  Prepared statement 33
John Koelemij, president, Orange State Construction Co., Tallahassee, FL, on behalf of National Association of Home Builders 38
  Prepared statement 41
Brian Chappelle, staff vice president for residential finance/government agency relations, Mortgage Bankers Association, Washington, DC 46
  Prepared statement 48
Dwight Ink, president, Institute for Public Administration, New York, NY 72
  Prepared statement 76

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Letter to Senator Graham, dated May 15, 1990, from WWH Properties, Inc., Paul B. Hazlett, president 99

MONDAY, APRIL, 23, 1990

EXECUTIVE AND OBM OVERSIGHT OF HUD

Opening statement of Senator Graham 105
Opening statement of Senator Mack 106

WITNESSES

Anne Banning, former Assistant Director, Office of Presidential Personnel; Charles Dutcher, former Assistant Director, Office of Presidential Personnel; and Mark Robbins, former Deputy Assistant Director, Office of Presidential Personnel 106
William Diefenderfer, Deputy Director, Office of Management and Budget, Washington, DC 134
  Past OMB Budget/management oversight of HUD 135
  Actions taken specific to HUD 135
  Current OMB management integrity program 137

Page
William Diefenderfer, Deputy Director, Office of Management and Budget, Washington, DC—Continued
  Future plans for OMB management oversight 137
  Conclusion 138
  Questions sent by Senator Graham 205
  Response to written questions 208
Frank Hodsoll, Executive Associate Director for Management, Office of Management and Budget, Washington, DC 139
Hugh Heclo, Clarence J. Robinson Professor, George Mason University, Fairfax, VA; former consultant to the President's Reorganization Project, Office of Management and Budget 162
  Prepared statement 166
Alan Dean, former senior management analyst at Bureau of the Budget; former Deputy Associate Director, Office of Management and Budget 184
  Prepared statement [Joint] 189
Harold Seidman, guest scholar, Center for the Study of American Government, Johns Hopkins University, Washington, DC; former Assistant Director for Mangement and Organization, Bureau of the Budget 187
  Prepared statement [Joint] 189

Additional Material Supplied for the Record

Institute of Public Administration, additional testimony of Dwight Ink, president 218
National Academy of Public Administration:
  Statement of the Standing Panel on Executive Organization and Management, by Alan L. Dean, president 230
  Report entitled "Revitalizing Federal Management": managers and their overburdened systems, November 1983 [Chapters 1 and 2 only] 252

FRIDAY, APRIL 27, 1990

LOW-INCOME HOUSING TAX CREDITS

Opening statement of Senator Graham 265
Opening statement of Senator Mack 267

WITNESSES

John M. Ols, Director, Housing and Community Development Issues, U.S. General Accounting Office, Washington, DC, accompanied by Dennis Fricke, Assistant Director 268
  Prepared statement 273
    Program background and tax credit utilization, 1987–89 275
    Syndicating low-income housing and the effect of passive activity rules 277
    Syndication structures vary widely 279
    Costs associated with syndicating tax credits 280
    Tax expenditure used to attract private investor capital 281
    Transaction costs for public offerings 283
    Direct corporate placements 285
    Conclusions 286
    Attachment I.—National summary of tax credit activity 289
    Attachment II.—State summary of tax credits usage in CY 1989 290
    Attachment III.—State summary of tax credits usage in CY 1988 292
    Attachment IV.—State summary of tax credits usage in CY 1987 294
    Attachment V.—Tax credit project syndication flow chart 296
William E. Haynsworth, Senior Vice President, the Boston Financial Group Inc., Boston, MA 303
  Prepared statement 335
Barton Harvey III, Deputy Chairman, the Enterprise Foundation, Columbia, MD 304
  Prepared statement 355
John Weicher, Assistant Secretary for Policy Development and Research, Department of Housing and Urban Development, Washington, DC accompanied by Fred Eggers, Associate Deputy Assistant Secretary for Economic Affairs 304
  Prepared statement 391

Page
Mark Hendrickson, [Representing the National Council of State Housing Agencies] Executive Director, Florida Housing Finance Agency, Tallahassee, FL 305
  Prepared statement 404
  Appendix to prepared statement 750
David Blattner, Assistant Commissioner for Examination, Internal Revenue Service, Washington, DC, accompanied by Susan Reaman, Assistant Branch Chief, Chief Counsel's Office 306
  Prepared statement 431
  Charts:
    1. Tax credits allocated 440
    2. Tax credits use with other subsidies 441
    3. Source of other subsidies used with tax credit 442
    4. The tax credit user 443
    5. Appropriations for major subsidy programs which can be used with tax credit 444
    6. Appropriations for major components of the section 8 program 445
James Logue, Deputy Assistant Secretary for Multifamily Housing, Department of Housing and Urban Development, Washington, DC 311

TUESDAY, MAY 8, 1990

CONGRESSIONAL OVERSIGHT

Opening statement of Senator Graham 447
Opening statement of Senator Mack 488

WITNESSES

Paul A. Adams, Inspector General, Department of Housing and Urban Development, Washington, DC 448
  Prepared statement 451
  Response to written questions of Senator Graham 550
Charles L. Dempsey, Former Inspector General, Department of Housing and Urban Development, Washington, DC 460
Frederick M. Kaiser, Specialist in American National Government, Congressional Research Service, The Library of Congress, Washington, DC 460
  Prepared statement 465
    Current statutory offices of Inspector General 467
    Reporting to the Attorney General 469
    Reporting to the establishment head and Congress 470
    Options for improving IG reporting and Congressional oversight 473
  Response to written questions of Senator Graham 556
Richard L. Fogel, Assistant Comptroller General, General Government Division, U.S. General Accounting Office, Washington, DC 492
  Prepared statement 495
  Response to written questions of Senator Graham 568
Stanley M. Brand, Brand & Lowell, Washington, DC 503
Richard A. Wegman, Garvey, Schubert & Barer, Washington, DC, on behalf of the National Academy of Public Administrators 505
  Prepared statement 508
    The challenges of effective oversight 509
    NAPA congressional oversight panel recommendations 511
    Preventing HUD's by getting capable, qualified management 511
    Changing congressional behavior 514
    Recommendations 517
Thomas E. Mann, Director, Government Studies Program, the Brookings Institution, Washington, DC 520
  Prepared statement [Joint] 523
Bert A. Rockman, Senior Fellow, Governmental Studies Program, the Brookings Institution, Washington, DC 519
  Prepared statement [Joint] 523
  Response to written questions of Senator Graham 577

Page

WEDNESDAY, MAY 16, 1990

REBUILDING OF HUD

Page

Opening statement of Senator Graham 581
Opening statement of Senator Mack 582
Opening statement of Senator Riegle 584

WITNESS

Jack Kemp, Secretary, Department of Housing and Urban Development, accompanied by Alfred A. DelliBovi, Under Secretary, and Frank Keating, General Counsel, United States Department of Housing and Urban Development 586
  Prepared statement 593
    Scope of the problem 595
    Management actions 597
    Relationship with Congress 599
  Response to written questions of Senator Graham 765

FRIDAY, JUNE 29, 1990

HUD IG AND SECRETARY'S SEMI-ANNUAL REPORTS

Opening statement of Senator Graham 627
Opening statement of Senator Mack 628

WITNESSES

Paul Adams, Inspector General, Department of Housing and Urban Development, accompanied by Chris Greer, Assistant Inspector General for Audits and Patrick Neri, Assistant Inspector General for Investigations 629
  Prepared statement 634
    The semi-annual report 636
    Overview of major problems 636
    Audit 638
    Management response to audits 646
    Investigation 647
    Significant investigations 649
    Closing agent cases prosecuted 650
    Prevention 652
    HUD staffing resources 654
  Response to written questions of Senator Graham 726
Alfred DelliBovi, Under Secretary, Department of Housing and Urban Development, accompanied by Lloyd Chaisson, Senior Advisor 664
  Prepared statement 669
    Introduction 669
    Staffing 671
    Monitoring 672
    Training 673
    FHA closing agents 675
    Retirement service centers 676
    Conclusion 678
  Response to written questions of Senator Graham 747
Paul Maloney, Deputy Assistant Attorney General, Criminal Division, Department of Justice 688
  Prepared statement 690
  Additional material supplied for the record 775
John Keeney, Deputy Assistant Attorney General, Criminal Division, Department of Justice 699
  Prepared statement 700
Frank Keating, General Counsel, Department of Housing and Urban Development 704
  Prepared statement 707

THE MISSION OF HUD
VOLUME I OF II

TUESDAY, JANUARY 30, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
HUD/MOD REHAB INVESTIGATION SUBCOMMITTEE,
Washington, DC.

The subcommittee met at 9:40 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Bob Graham (chairman of the subcommittee) presiding.

Present: Senators Graham, Riegle, Bryan, and Mack.

OPENING STATEMENT OF SENATOR GRAHAM

Senator GRAHAM. Good morning. This is the first of a series of hearings by the Subcommittee on HUD/Mod Rehab Investigations, which has been established under the leadership of Chairman Donald W. Riegle, Jr., of the Banking, Housing, and Urban Affairs Committee.

I wish to begin by expressing my appreciation to the chairman for his interest in the subject and his confidence in the members of this subcommittee to carry out an appropriate review of the Department and be prepared to make recommendations to the full committee and the Senate relative to what reforms these hearings indicate are appropriate.

Almost a year ago, in April 1989, HUD Inspector General Paul Adams released a report which opened the eyes of the Congress and the Nation to the flagrant abuses that were occurring within the Department of Housing and Urban Development.

As we watched hearings in the House and Senate unfold, we learned such things as how funds intended to help the neediest had been diverted into the hands of the rich and influential.

We have seen how neglect and mismanagement left the Department handicapped and unable to effectively deliver its services. We have witnessed what can happen when persons hostile to the mission of the organization are placed in charge and no one outside the agency keeps a watchful eye.

1989 was a difficult year for HUD. The agency has been put under the microscope by Congress, the public, and the press.

Our focus in this series of hearings will be on mending the problems of the troubled agency. We will not be spotlighting the personalities involved in the scandals. Rather, we will focus on statutory, regulatory, and management practices which need to change in order to put the agency back on its feet.

We will begin this series of hearings on a positive note. Today, we are honored to have with us several individuals who played leadership roles and made significant contributions to the Department and to housing policy for half a century.

We have asked these individuals to share their thoughts on the current status of HUD, particularly the mission of the agency, its management and oversight. Oversight by the executive and the Congress.

[The prepared statement of Senator Graham follows:]

PREPARED STATEMENT OF SENATOR GRAHAM

Good morning. Almost one year ago in April, HUD Inspector General Paul Adams released the report which opened the eyes of Congress and the Nation to the flagrant abuses occurring in the agency during the Reagan administration. As we watched hearings in the House and Senate unfold, we learned how funds intended to help the neediest were diverted into the hands of the rich and influential. We have seen how neglect and mismanagement left the Department handicapped and unable to effectively deliver its services. And, we have witnessed what can happen when persons hostile to the mission of the organization are placed in charge and no one outside the agency keeps a watchful eye.

This has been a difficult year for HUD. The agency has been put under the microscope by Congress and the press. Our focus in this series of hearings will be on mending the problems of the troubled agency. We will not be spotlighting the personalities involved in the scandals. Rather, we will focus on the statutory, regulatory, and management practices which need to change in order to put the agency back on its feet.

We will begin this series of hearings on a positive note. Today, we are honored to have with us several individuals who have played leadership roles and made significant contributions to HUD and housing policy since the early 1960's. We have asked these individuals to share their thoughts on this scandal, in particular focusing on the mission of HUD, management, and oversight.

Before we begin, I would like to take a moment to introduce my distinguished colleagues who will be serving with me on this subcommittee. The ranking minority member is Connie Mack and subcommittee members are Richard Bryan, Richard Shelby, and Kit Bond.

Senator **GRAHAM**. Before we begin, I would like to introduce the distinguished chairman of the Banking, Housing, and Urban Affairs Committee, Senator Don Riegle, for whatever comments he would like to make as we begin this series of hearings.

OPENING STATEMENT OF SENATOR RIEGLE

Senator **RIEGLE**. Thank you very much, Senator Graham.

During the last year, the Banking Committee conducted six hearings into the abuses surrounding section 8 Moderate Rehabilitation Program in the Department of Housing and Urban Development.

The focus of that inquiry was to determine how Mod Rehab, which had been determined to provide modest incentives, could, in turn, generate sufficient cash flows to justify the payment of large consulting fees to top former HUD employees and to former Cabinet officers, such as the James Watt example, which is well-known to all.

In testimony before the committee by GAO and others revealed how Mod Rehab subsidies were layered with one or another Federal and State subsidies to actually create a windfall profit for developers without providing additional units of housing for low-income families.

Today, under the leadership of Senator Graham of Florida and Senator Mack of the HUD Investigation Subcommittee, this new effort will undertake an inquiry into additional areas of concern not addressed by our earlier hearings.

This will include review of HUD management of staffing, incentives offered by HUD to developers of low-income housing, and the oversight role of Congress, OMB, and the White House.

Our distinguished witnesses this morning are all profoundly well-acquainted with the inner workings of the Department of Housing and Urban Development over many long years, having held some of the top policy-making positions with that Department.

I especially want to welcome before the committee two former HUD Secretaries, Mr. Robert Weaver and Mr. Robert Wood. And we are interested in the views of all.

I also want to acknowledge particularly the presence of Dick Van Dusen, who is here from Michigan and who not only represents his own personal experience as a former Under Secretary but also comes, I'm sure in spirit, on behalf of former Secretary George Romney, whom we in Michigan are very proud of and who is a man who played a very important part in my start in politics, which I remember and appreciate.

With that, let me just say that this subcommittee is in the very able hands of Senator Graham, and we very much look forward to hearing from you this morning.

[The prepared statement of Senator Riegle follows:]

PREPARED STATEMENT OF SENATOR RIEGLE

During the last year, the Banking Committee has conducted six hearings into the abuses surrounding the section 8 Moderate Rehabilitation Program and the Department of Housing and Urban Development.

The focus of our inquiry was to determine how Mod Rehab, which had been intended to provide only modest incentives, could generate sufficient cash flows to justify the payment of large consulting fees to former top HUD employees and Cabinet officials like James Watt. And testimony before the committee by GAO and others revealed how Mod Rehab subsidies were layered with other Federal and State subsidies to line the pockets of developers without providing additional units of housing for low income families.

Today, under the leadership of Senator Graham of Florida, Senator Mack, and the HUD Investigation Subcommittee, the committee begins a new inquiry into additional areas of concern not addressed by our earlier hearings. This will include a review of HUD management and staffing, the incentives offered by HUD to developers of low income housing, and the oversight role of Congress, the OMB, and the White House.

Our distinguished witnesses this morning are all well acquainted with the inner workings of the Department of Housing and Urban Development having held some of the top policy making positions within that Department. And I am pleased to welcome before the committee two former HUD Secretaries, Robert Weaver and Robert Wood, and to hear your observations.

I am particularly interested to learn from each of our witnesses their views on how we can best determine the level of incentives that are necessary to encourage private sector development of affordable housing.

At this point, I will yield, and I look forward to hearing from each of the witnesses this morning.

Senator GRAHAM. Thank you very much, Mr. Chairman.

Before we proceed with the statements and questions, I would like to introduce some of the members of the staff that have come at considerable personal sacrifice to serve this committee, and I believe will give us the ability to carry out our task at a very high level.

First, I would like to introduce the general counsel of our staff, Mr. D'Alemberte. His colleague, who will be particularly representing the minority on the committee, Mr. Jim Watt.

We have regular members of the Banking Committee and others who will be specifically serving this subcommittee.

I wish to express my appreciation to all of you for your personal involvement.

The hearing today will focus on, first, a series of distinguished Americans who have all served in high policy positions in the Department and then a panel of academic experts who will provide their focus on the Department and Housing policy.

We have been joined by the ranking minority member of the subcommittee, my colleague from Florida, Senator Connie Mack.

Senator, if you would have any opening statement before we proceed.

Senator MACK. Thank you, Mr. Chairman.

I look forward to working with you on this committee. I have a prepared statement, which I would just submit for the record.

[The prepared statement of Senator Mack follows:]

PREPARED STATEMENT OF SENATOR MACK

Mr. Chairman, it is indeed an honor to be here and share a place on this panel with my distinguished colleague, my fellow Senator from the great State of Florida, Bob Graham.

It is not a particularly pleasant matter that brings us together here today, however. We are all aware that a serious discrepancy between intent and implementation in Federal housing policy has occurred, and it is the mandate of this panel to investigate this discrepancy.

To a certain degree, the efforts of this panel will be similar to those of the other body's banking committee which investigated allegations of wrongdoing at the Department of HUD, as well as HUD's own inspector general who is conducting an ongoing investigation.

I believe this panel will differ in substantive ways, however, from the other investigations. The most important difference is that this panel intends to examine the nature of the programs that had invited misuse, rather than scrutinize the people and personalities that had been accused of wrongdoing.

This is an important difference. There is strong indication that the structure of at least some Federal housing programs is badly flawed. They actually seem to provide incentives for Federal money to be used toward ends that are at odds with the goals of Federal housing policy. Whether this is because of congressional inability to devise appropriate housing programs, or whether it is because of a fundamental misunderstanding of what constitutes appropriate Federal housing policy is not clear at this point. But I hope that our investigation will provide the answer to these kinds of questions.

Whatever the outcome of this investigation, however, I am optimistic about the future of housing policy under the direction of my good friend and former colleague, Jack Kemp. His advocacy of vouchers, housing opportunity zones and tenant management and ownership represents an acceleration in the movement toward the goal of better housing opportunities for everyone. I believe this approach will be immeasurably more effective than that which is referred to as traditional housing policy.

Senator MACK. Maybe just one comment.

During the past several months, I have had the opportunity to travel to a lot of different cities in Florida to look at public housing and to talk with people who have been active in public housing authorities, people administering different programs.

I spent a fair amount of time talking with residents in their units. I saw a wide spectrum of both good and bad, I guess. The one image that sticks out in my mind was a fellow by the name of Eddie Taylor down in Melbourne. We had gone into one unit that was totally destroyed. It looked like it probably was being used every now and then by someone involved in drugs, possibly.

This was in terrible shape. As we stepped out of that unit, Eddie looked down the way and saw a young boy, probably 2 or 3 years of age, walking down the walkway between these two buildings.

He said:

> Senator, the problem is that that little boy, as he looks around, he thinks the entire world is like this. And somehow or another, we have to do something to change his perspective.

So I'm hopeful that, as we go through these hearings, that while our primary purpose initially is not one of designing policy, what we are trying to find out:

Where are the areas we made mistakes in the past?

What kinds of things can we be doing differently in the future that, in fact, can help change that little boy's perspective?

So I look forward to your testimony.

Senator **Graham**. Thank you, Senator.

Before we begin, it's the practice of the Senate Banking Committee in all of its hearings to have all witnesses sworn. I would ask if you would all please rise and raise your right hand.

[Witnesses sworn.]

Senator **Graham**. Our first two speakers who have presented a joint written statement are two former Secretaries of the Department, Robert Weaver, Secretary of the Department from 1966–68; and Robert Wood, Secretary of the Department from 1968–69.

I would ask Secretary Weaver and Secretary Wood if you would make your statement, after which we will have one round of questions. Then I will call on the other three members of the panel for their statements. And then we will have a round of questions for all five of the members of this panel.

Before we begin I have a statement from Senator Shelby.

PREPARED STATEMENT OF SENATOR SHELBY

Mr. Chairman, first let me commend you for scheduling this hearing so promptly. I think that it is extremely important for Congress to sort out what went wrong in the housing programs and policies of the last decade as quickly as possible so that we might finally turn our attention toward improving the availability of decent, affordable housing for all Americans.

We came very close to having a housing bill last year but the momentum was destroyed by disclosures of abuse and manipulation of several important HUD programs. It would have been inappropriate to redirect housing policy without first making sure that HUD was in a position to properly carry out its new mandate.

However, while the momentum may have slowed, it is my hope that it has not come to a halt. We need to improve housing in this country. After 8 years as a repository of political patronage jobs, HUD has been revitalized with energetic, visionary leadership and can-do, capable staff. However, I must echo a point that one of the witnesses, Anthony Downs of the Brookings Institute, makes in his testimony. There will be no improvement in the availability of decent, affordable housing for all unless we see a marked change in attitude from the President on down toward the role that HUD can and should play in meeting America's housing needs. President Bush speaks of a kinder, gentler Nation but the gap between the haves and the have nots will continue to widen without a comprehensive Federal response to the problems of poverty.

Housing is fundamental to the economic strength and competitiveness of this Nation. Without a safe, clean place to call home, it is difficult to work and to learn. We will not obtain the best from the American work force as long as the numbers of the homeless continue to rise, as long as parents fear daily for their own safety and that of their children in public housing projects, as long as the residents of public housing remain caught in a cycle of dependency.

The efforts of this subcommittee are tangential to those of the housing subcommittee. We must ensure that HUD is in a position to effectively administer a new direction in housing policy. But we will need the help of the administration. HUD must be willing to do more than pay lip service to the need for a revitalized housing policy. A signal from the White House is necessary. It is time for the administration to take the high road on this issue and respond to the needs of the millions of poorly housed Americans. The social and economic dividends to be gained are enormous and are an integral component of this country's ability to meet the competitive challenges of the next century.

I appreciate the work done by the distinguished chairman of this subcommittee and I look forward to the testimony of the witnesses. I regret that conflicts prevent me from attending this morning's hearing but I will look over the transcript later.

Thank you, Mr. Chairman.

Senator **GRAHAM**. Secretary Weaver.

STATEMENT OF ROBERT WEAVER, FORMER SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, PROFESSOR EMERITUS OF URBAN AFFAIRS, HUNTER COLLEGE, CITY UNIVERSITY OF NEW YORK; AND ROBERT WOOD, FORMER SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, HENRY R. LUCE PROFESSOR OF DEMOCRATIC INSTITUTIONS AND THE SOCIAL ORDER, WESLEYAN UNIVERSITY, MIDDLETOWN, CT

Mr. **WEAVER**. Thank you, Mr. Chairman. In his letter of invitation, Chairman Robert Graham asked that we limit our opening remarks to 5 minutes while the subcommittee considers key policy questions concerning the mission, management, and organization of HUD programs.

It does so in the context of apparent unwarranted misuse of scarce Federal resources and scandals. We take this request to mean that initially we should simply highlight the topics and issues we are prepared to treat in the full and free discussion that follows.

In fact, to further conserve time, we offer this statement jointly. This joint exercise comes easily because we were, indeed, present together at the creation of HUD. We have been fellow professionals in Urban Affairs for years before.

Wood had been a consultant to Weaver when the latter was HHFA administrator and we shared then and share now a common approach and philosophy in urban policy-making.

In short, we have been colleagues by necessity and friends by choice in the continuing exploration of the appropriate Federal role.

Our common point of departure in 1965 and now was the preamble of the bipartisan 1949 Housing Act, which Senator Paul Douglas and Senator Robert Taft crafted together. The now familiar mission statement of that act accepted as a Federal responsibility the need to facilitate the provision of a decent home in a suitable environment for every American family. Two closely linked goals:

Good housing and good places in which to build them were the commitment then, and HUD was the organizational structure designed to provide them more effectively and in more balanced proportion than its predecessor, HHFA.

I was the organizational architect of HUD establishing the framework for carrying out community planning and development functions, as well as housing programs, and establishing unique line staff positions for the Department's assistant secretaries.

I also took the leadership in drafting and prescribing the 1968 Housing and Urban Development Act, taking the research and findings of the Kaiser Committee and developing the first quantitative commitment of 26 million housing units made in the housing field.

I look forward to elaborating on these issues to the extent the subcommittee wishes.

Secretary Wood had a hand in shaping the 1966 Housing and Urban Development Act, which was the first substantial effort to combine physical and social planning and development assistance in neighborhoods.

And because of the prior experiences in the Executive Office of the President, he also took responsibility for making internal administrative arrangements to ensure that allegations of misconduct, conflict of interest, and unethical behavior were properly and effectively dealt with.

He can expand on these topics.

We also hold views, as we are sure our successors in subsequent administrations do as well, on what the 1990's require for effective housing and urban policy; which programs undertaken in our time might be useful and which might not given the dramatic demographic and economic changes of the last 20 years.

We will be glad to spell them out here or in later submissions to this committee. For the present, we are just glad that the Senate has undertaken this initiative. We are pleased to be here and will be of any help we can.

Thank you.

[The prepared statements of Robert C. Weaver and Robert C. Wood follow:]

OPENING STATEMENT

ROBERT C. WEAVER
ROBERT C. WOOD

UNITED STATES SENATE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS

SUBCOMMITTEE ON HUD/MOD REHAB INVESTIGATIVE SUBCOMMITTEE

January 24, 1990

In his letter of invitation, Chairman Bob Graham asks that we limit our opening remarks to five minutes as the subcommittee considers key policy questions concerning the mission, management, and organization of HUD programs. It does so in the context of apparent unwarranted misuse of "scarce Federal resources" and "scandal." We take this request to mean that initially we should simply highlight the topics and issues we are prepared to treat in the full and free discussion to follow. In fact, to further conserve time, we offer this statement jointly.

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Secretary Wood had a hand in shaping the 1966 Housing and Urban Development Act, which was the first substantial effort to combine physical and social planning and development assistance activities and to test the capacity for turnabouts in urban neighborhoods. Because of prior experience in the Executive Office of the President, he also took responsibility for making internal administrative arrangements to ensure that allegations of misconduct, conflict of interest, and unethical behavior were promptly and effectively dealt with. He can expand on these topics.

We also hold views, as we are sure our successors in subsequent administrations do as well, on what the 1990s require for effective housing and urban policy; which programs undertaken in our time might be useful and which might not, given the dramatic demographic and economic changes of the last 20 years. We will be glad to spell them out here or in later submissions to the Subcommittee.

For the present we are just glad that the Senate has undertaken this initiative. We are pleased to be here and will help out in any way we can.

Senator GRAHAM. Secretary Wood, would you care to amplify on those remarks?

Mr. WOOD. I think I will say Secretary Weaver and I began years ago. I'll say I subscribe to every comment the Secretary has made and endorse it.

I would add simply, Senator, that I think one of the most interesting parts of your inquiry could be simply a dispassionate and objective look on what works and what doesn't work in urban policy, because over my years, some of my colleagues in academia tended to dismiss all of the measures that were passed in the 1960's and 1970's. I think it's time for an objective and clear look. And I look forward to that.

Senator RIEGLE. Mr. Chairman, before you proceed, I wonder if you would just allow me one personal comment.

As you were testifying, I was dusting off some memories. I had the good fortune to arrive here as a newly admitted member of Congress in 1966, so I got here in time to be present during the period in which our two speakers were in the saddle at the Department of Housing and Urban Development.

One of the great moments at that time, Lyndon Johnson was in the Presidency, was the Open Housing Act that we were able to enact at that time with bipartisan support.

I was struck by the reference to Robert Taft and Paul Douglas working together to set forward housing goals for the country.

I recall, during that period of time, that it was the votes of Members of both parties that enabled us to pass the Open Housing measure.

In any event, it brings back some very special memories.

Senator GRAHAM. Thank you, Mr. Chairman.

Our central focus is going to be to understand both the historical evolution of this Department, the social and economic context in which that evolution has taken place, and then the likely or potential future direction of the Department, all of which to better understand the recent past and what corrections are necessary in order to move to the future.

You outlined, Mr. Weaver, the rationale upon which the 1949 Housing Act, which was one of the precursors of this Department, was passed.

How would you describe their appropriateness today as a statement of what should be the Nation's commitment to housing its people?

Mr. WEAVER. I think the philosophical statement of having a goal of a decent home and a suitable environment is still appropriate. However, I don't believe that the thing that we did, which was to quantify that statement of policy and then to set a time limit—10 years—in which that would be met, I think this would not be appropriate today; because I don't think we have the housing shortage to the extent that we had it at the time when that was written.

However, I still think that, in the current years when everybody is talking about housing allowances and having demand approaches to housing, that is short-sighted because we do have many areas in this country where there is a tremendous shortage of decent, low-income housing. And that cannot be met by a supply approach because it would be like Medicare:

When you come in and increase the demand very greatly, the price goes up. Then you exclude a lot of people who are low in income from participating.

So, my theory is that you must have both demand-oriented approaches and supply oriented programs, as with the type of legislation that we enacted in 1968; what the mixture between the two should be has to vary from time to time and area to area. There is no one-way street of solving this very difficult and important problem, in my opinion.

Senator **Graham**. Mr. Wood, if you would care to comment on any of the questions, if you would indicate, we would be interested in your amplification.

Mr. **Wood**. Well, I won't comment on this one. I may amend or elaborate later on.

Senator **Graham**. Were there any unusual factors that developed in the last decade that created the environment for the circumstances that created the crisis of the Pierce years?

Mr. **Weaver**. I may want to explore this a little more later, but I think that the situation which we had in the eighties was unique. It was unique in the fact that it wasn't an isolated incident. It wasn't a single development that happened by itself.

But, it was a series of circumstances. If you look at them, you'll see they all go back to a common philosophy and to a common ideology.

In other words, if you look at Mod Rehab, as I'm sure you are doing, you will find that there are many basic factors involved.

First, the political preference situation that occurred.

Second, the idea of privatization, which means taking less and less government into the activity and putting more and more into the private area.

Third, a tremendous cutback in personnel, going from 16,000 to about 12,500. And also a tremendous turnover at the top, where you had 10 assistant secretaries for housing, I mean, 8 assistant secretaries for Housing in 8 years, and where the post of the Under Secretary was vacant for a couple of years.

All of this meant that the staff was demoralized and you had a lack of sufficient people to do the type of surveillance that has to be done. And under privatization, as the General Accounting Office reiterated, you don't need less surveillance; you need more.

The Department moved in the wrong direction. So it isn't just one incident.

I think previous scandals, and there haven't been too many, were usually of one or two dimensions. But, this one was multidimensional and it's to the very fundamentals of the administrative structure and of the administrative policy.

Mr. **Wood**. Mr. Chairman, I might add on that point two characteristics of the Department.

One is, as we indicated in the joint statement, that HUD was deliberately designed to have its assistant secretaries, its Presidential appointments to have both line and staff positions. I think what our objective was with that was to bring under at that time, under Presidential supervision or supervision by Presidential appointees, the program management aspects that had previously been in the hands of bureau chiefs.

And the concern at that time was that the bureau chiefs were not being responsive to the President with an overwhelming mandate and majority through his appointees.

That puts on the initial Presidential appointees a heavy learning curve problem of catching up on what the technical characteristics of the program are. Therefore, you find part of that I think in the turnover rate that Secretary Weaver just described.

The second point to reinforce is that, in 1978, the HUD operating budget, personnel budget, was about 8 percent of the total Federal establishment budget. It had fallen by 1988 to 1 percent.

So that the real emasculation and reduction of professional staff was a significant and remains a significant aspect that Secretary Kemp faced when he came in.

Mr. **WEAVER**. May I just add one word?

Overcutting the budget, most of it was through assisted housing, which is directed to poor and low-income people. That, of course, in my opinion, is what should be emphasized rather than help to those who are more affluent and don't need that help as much.

Senator **GRAHAM**. My 5 minutes are up.

Senator Mack.

Senator **MACK**. Thank you, Bob.

I want to follow up on the comment by Secretary Wood, just to try to put this in perspective for me. Maybe it would be helpful for me to understand how the management system differs today from when you all put it together, or when you were operating with it.

Is that management system in the sense of who reports to who and for what reasons one of the factors that we should be looking at?

Mr. **WOOD**. I would think so. Under Secretary Van Dusen and John can handle history as it runs through the years. We can perhaps get into that fascinating question of regional decentralization and who is allowed to sign off on a congressional inquiry.

That of course is always interesting. But, essentially, I think that the line staff blending remain. And I'm prepared in a sense to defend that in terms of if a Presidential appointee comes in with an expectation of being here for 3 or 4 years, because I think that does make the implementation of the policy more likely, more effective and more efficient, what it does do, however, is suppress the technical skills of your professional civil servants.

And whether or not the civil service reorganization Alan Campbell produced, whether or not that has made a significant difference, I just don't know.

Senator **MACK**. Secretary Weaver.

Mr. **WEAVER**. I'd like to make two comments on that.

First, I think that the mission of the Department is really set forth in the authorization of it. And the first item in that is that the Department should be concerned with bringing together the various constituent elements and getting them to work together.

This is why we had the rather unorthodox—I think it's the only time it's been done—idea of line and staff. I must say, the Budget Bureau, I think, looked at me with very, very dubious eyes about this, and they finally came along. But, they modified their recommendation to say:

Well, half of them would be line, and half of them would be staff, which I thought was a terrible compromise.

But, anyway, assistant secretaries were line when they operated and managed specific programs. They were staff when they joined the Under Secretary to be my principal advisors. And in that way, they got to know what was going on in the whole Department.

An additional activity which was pseudovoluntary, we ate dinner together every Tuesday in the month. Nobody but the top people. No substitutes. And there was no excuse not to be there because you knew it was scheduled.

This also—no agenda—began to bring these men—unfortunately, they were only men in those days. But I had recruited a female commissioner of public housing. At least I have something on my record in that regard.

This I thought was a very helpful thing and it worked pretty well.

Senator **Mack**. Let me go back to your opening comments with respect to at one point there was the goal of 26 million units, I think you mentioned, in a 10-year timeframe, and indicate that that would really not be appropriate today.

Are you saying that in the sense of both the amount and the time or just the processing?

I realize that you said today we really don't have the same housing needs in a sense of structures, I guess.

Mr. **Weaver**. I think it's important to remember, too, that it was a total figure of 26 million. There was also a figure that 6 million of those had to be for lower income families.

I have a feeling that certainly those figures would not stand up today. As a matter of fact, I'm not too sure that they stood up at the time because the demographers were a little off on their prognostications. Those were what we based the estimates on.

Mr. **Wood**. There is a record, Senator, on the 26 million 10 years out; 18.8 million were for regular housing and 6 million for low and moderate income.

The Departments over the years filled 94 percent of that 18.8 of the sort of middle class housing, and managed to achieve only 45 percent, 2.7 of the housing for low and deep dish subsidy.

So that one of I think the paradoxes of HUD and its mission is that, on the one hand, it wants to provide major affordable housing for a majority of Americans. On the other hand, it has a special obligation to poverty. It has difficulty.

And this I think is Secretary Weaver's sort of supply and demand combination, region by region. It has difficulty putting this together coherently, in a coherent fashion.

Senator **Mack**. The only thing I would say, because my time is up but we can get back to it in a few minutes, maybe, but I'd like to come back to those 18 million units and 84 percent attaining of the goal, and the 6 million and 42 percent, and address what programs were helpful in reaching that 84 percent and which ones were helpful in reaching the 42 percent of the 6 million.

Mr. **Weaver**. Let me say at this point that one of the reasons that we didn't reach the quota for the less affluent was the fact that there was a moratorium placed on assisted housing in 1973.

We had a couple of years where nothing was getting in the pipeline, and housing is a long lead time activity.

If you stop housing starts now, you're going to see the results anywhere from 18 to 24 months later.

The other thing I'd like to say, that I think is very important, is that the main thing this taught us is the fact that our housing industry in this country is capable of producing housing at a much higher rate than it has had in the past. And that that capacity is there.

The problem of course is that the credit is not always there. But I think this was an important lesson, because most economists didn't think it could be done. They said it was unrealistic.

It wasn't unrealistic because of capacity; it may have been unrealistic for other reasons.

Senator GRAHAM. Thank you, Mr. Secretary.

We have been joined by another member of the subcommittee, Senator Richard Bryan of Nevada.

Senator Bryan, do you have an opening statement?

Senator BRYAN. Mr. Chairman, I do not. When it comes time, I'd like to ask some questions.

Senator GRAHAM. Thank you, Senator.

Senator Riegle.

Senator RIEGLE. There's just one thing I'd like to raise. I value the perspective and the way it helps us think about the manner in which programs were conceived and conceptualized. I sense that over the years there's been really a very radical change in many ways, some very subtle; some that I hope we're wise enough to discern in the course of our hearing process to try to figure out where we are today. Obviously, the low income person and the homeless person whose out there is very much dependent upon our ability to set objectives and meet them efficiently and effectively.

I don't think that we're doing a very good job just by the evidence that one sees. We have run out of hot air grates in Washington, as you know. We've got more people trying to get out of the cold and keep from freezing to death in the wintertime than we can presently handle in this city, and it's not unique to Washington.

All over the State of Michigan we have this going on in virtually every community as well.

Let me ask you this question.

One of the things that marks the abuses of this last few years is this wearing of subsidies from different directions. The GAO and others have shown how developers have been able to do this in a fashion where they've earned enormous profits from their activities.

There's an example in one case where the GAO reports that a developer made a nearly $2 million profit from his original investment of $54. It raises the question of how much incentive should the Federal Government provide to encourage private sector development of affordable housing, and should we be thinking somehow of limiting the developer's return to a fixed percentage, say, 10 or 15 percent? Or should we be requiring the developer to make a minimum equity contribution to the project?

Or, how do we go about getting value, reasonable profit margins and, at the same time, hopefully, enhance the volume of business that we do.

I'm just wondering what thoughts you might have in that regard.

Mr. **Weaver**. I think Mr. Brownstein would answer that probably better than I. But I do want to point out one thing. That is the fact that:

In this Model Rehab, one of the factors was that the program had been run before it got into difficulty largely by the regional offices, which used local public housing authorities which had competitive bids.

And when the program became politicized, it was brought into the central office. There were no competitive bids. That's just asking for difficulty.

Mr. **Brownstein**. Do you want me to come in at this point?

Senator **Graham**. This is Mr. Philip Brownstein, former Federal Housing Commissioner from 1963–65, an assistant secretary for mortgage and credit during the administration of Secretary Weaver.

Mr. **Brownstein**. Bear in mind that the subsidy has to do two things. In the first place, it has to get the rent levels down to a point where the person who is in need is able to pay whatever the level of rent is.

Second, there has to be an adequate incentive provided for people to get into this and to invest in these kind of projects.

I don't believe, Senator Riegle, it's possible to quantify precisely the amount of subsidy that is needed. There are three elements that developers consider or any real estate investors consider.

There's cash flow. There's the possibility of appreciation. And there is the question of tax treatment.

On the latter, the tax treatment, the incentive was largely dissipated in the 1968 tax law.

So we are left with the other two.

Appreciation these days is a factor that really is very problematical in dealing with low-income projects. The degree to which those projects are going to appreciate over the years is very hard to gauge, so we get the cash flow as the element of subsidy that's needed.

When we were in the Department, we had a program of subsidy that was called a Limited Dividend Program. That was the 221 (b)(3) below market interest rates program.

We limited the amount that an investor could take out of the project, the 6 percent of the investment, and by investment, we calculated that to be 10.11 percent of the mortgage amount.

Is that the right number?

Today, probably not because of the loss of the tax benefit.

Also, it was discovered that those projects didn't appreciate the way a good many of them had expected that they would.

So, the investment has to be competitive with what other real estate investments will produce. Those having similar risks. And these are risky. But, to quantify it precisely is impossible.

Senator **Riegle**. That's helpful.

Just one other thing. That is, you talk about the question of the tenure of the people at the top and the degree to which you get the rollover phenomenon and who has the responsibility and who keeps track of running the show properly.

The last HUD Secretary was there 8 years, I think the longest stint of anybody in the Reagan Cabinet. And also probably one of the longest Cabinets, 10 years, in any Department. So there was certainly a lengthy period of service.

It appears, however, that, in that case, it worked against us. And I don't mean to try the Pierce case here, but it looks as if what happened the next tiers down is that you had a very politicized process. You had people who seemed to be making decisions, from what one can gather, on the basis that was quite far removed from any kind of careful dollars and cents analysis of how do you get the highest amount of low and moderate income housing yield per dollar spent.

It looks like what we got to is a pattern of very intense political favoritism. That's not new to say, it's been out there as a matter of record.

What thoughts do you have as to how we put a stop to that?

Mr. **Weaver**. I think that in the structure we had, and I believe it's true now, it is the Assistant Secretary who runs the program. The Secretary just can't do it. But he is supposed to be on the job and he's supposed to be watching what's going on. He's supposed to get information and he's supposed to be alerted when something is going wrong.

Bob Wood said he was primarily looking at that side of the activity, although we had people in FHA doing it, we had people in the central office doing it and we had people in one of the other major programs, which I forget at the moment.

So that this is very important.

Second, one of the things that I did was to decentralize the program. I decided when I came in, something had to be done. Under HHFA, we had regional offices where some of the constituent agencies were in one city, some were in another city. If they were in the same city, one might have an office over in the central part of town, the other one near the suburbs.

This just doesn't make any sense. So what we did was to give the regional administrator the power to speak for the Department in his region.

Second, we had him as a line person reporting directly to the Secretary, handling five or six different programs, depending upon where they were. He was coordinating it at that level while we were attempting to coordinate it in the Washington level.

And I think this is a rather healthy thing to have as contrasted with putting it out from the Washington regional office, because very often they know much more than we know in Washington about what's going on. And they know very much more about whose going on than we do.

Mr. **Wood**. The one other point, Senator, in terms of Secretary Pierce and his tenure, the people at the top have to listen. Our time was prior to the inspector general, but we had an administrative investigatory facility and Bill Smith, who then became deputy commissioner of New York City Police, came weekly on any allegation of misconduct or misbehavior.

And we made that judgment and then took it to the Secretary. And Secretary Van Dusen can say how it worked, but you basically—it was an awareness that you take seriously, allegations, that a pattern will emerge from them. And you take corrective action as quickly as possible.

Senator **Riegle**. Thank you.

Senator **Graham**. Senator Bryan.

Senator **Bryan**. Thank you very much, Mr. Chairman.

Let me, if I may, Mr. Weaver, follow up on a question that Senator Riegle asked.

You make an argument in light of the recent experience, I tend to give it great deference, that part of the strength of the system when you were there is that it was decentralized. The decisions were made on a regional basis and you just made the comment that they know much more about the local situation than do those of us here in Washington.

I could go into that a great deal more with you, but my question is from an overall administrative control.

If you do decentralize it, how do you get uniformity in the application of the law?

Don't misunderstand. I'm not advocating a centralized concept. But I think you would agree that you can't allow this region to handle the same type of situation differently from another region.

Mr. **Weaver**. I think the central office has to establish policy. And it has to establish procedures.

What we did was, by having the regional administrators reporting to me, I was able to find out what they were doing and how they were doing it. I had people on my staff who went out to see what they were doing.

Second, one of the things that we did was to raise the quality of the regional administrators. We insisted they come in with some knowledge and some experience. And we had two very difficult problems—one in New York City, which was then my adopted hometown, and one in Chicago.

And where we had to put in a regional administrator, certainly in Chicago, who was not Mayor Daly's favorite.

We had a long, long fight. I insisted upon it. We finally won and got the guy in there. He may still be there. He was there certainly during the time of Secretary Romney. And he was a very knowledgeable and very able guy.

But I think that quality of people is just as important as any procedures you set up because they're no better than the people who carry them out.

Mr. **Wood**. The other comment, Senator, is simply where we were in primitive days so far as management and information systems were concerned, the Senator and I both managed to avoid learning the computer in any of its phases at that time.

Nonetheless, we did begin to put in under Deputy Under Secretary Ross a set of reports and evaluations, and evaluations and information systems now are far more sophisticated and probably far more effective.

Senator **Bryan**. Mr. Wood, let me invite a question if I may.

I apologize to Mr. Weaver. I was here late. I know you commented briefly, I'm told, on the structural changes that you feel might be necessary in this agency.

Mr. Wood, if you did not get a chance to comment, may I invite your comment as to looking at the way it's structured now, what changes, if any, do you think need to be made into the organic act itself, for lack of a better term, acknowledging the importance of the quality of individuals and the decentralized concept that both of you have talked about.

Are there any structural changes? Does Congress need to look at this act and say the way it's set up structurally needs a fundamental overhaul, a fine-tuning? Or, are we OK with the structure?

Mr. **Wood**. When HUD was established, Senator, we won some and we lost some. We lost the so-called Poverty Program, the CAP. We lost the environmental oversight. We won on the transportation at that time.

The issue is simply how in one Department you try to bring together this complicated function and activities that the Secretary has described.

I do not think a full-scale reorganization in terms of functions is probably feasible or in order at the present time. I believe that HUD will always be the natural enemy of the Treasury. And I think, as I told one headhunter early on during President Carter's time:

"Make sure that whoever the Secretary is understands that the Treasury will be in confrontation."

And I think those are the facts.

I believe where I would go now is to emphasize more than we have in the past that aspect of metropolitan development and that aspect of regionalization that Secretary Romney was a great advocate for in his so-called Real City.

I think you see now in transportation, in affordable housing, in land policy, I think you see now an opportunity for that Department to move in what we used to call COG's, Council of Governments, in a metropolitan way with a far greater emphasis than I think we were able to give it.

So that would be the items that I think I would recommend as you look again to a restatement of HUD.

Mr. **Weaver**. Also, the statement of the purposes of the Department mentions specifically working with the States in certain areas. I say that because, again, regional or areawide planning is something that can't be done from Washington; it's going to have to be done, in my opinion, in the States, because they have the power to do it. We do not have the power to do it because any powers that we have are residual; that is, the States start out with the powers.

So this means carrying out that aspect of the original intent of the law.

Senator **Bryan**. Thank you, Mr. Chairman.

Senator **Graham**. Thank you, Senator.

At this point, I would like to call on the other three members of the first panel, whom I will introduce briefly at this time. And then call on them in the order introduced.

Mr. John Rhinelander, who was Under Secretary of the Department of Housing and Urban Development during the administration of Ms. Carla Hills from 1975–77; Mr. Richard Van Dusen, who was Under Secretary of the Department during the Romney administration from 1969–72; and Mr. Philip Brownstein, Federal Housing Commissioner from 1963–65, and Assistant Secretary for Mortgage Credit during the administration of Secretary Weaver.

Mr. Rhinelander.

Mr. **Rhinelander**. Mr. Chairman, Mr. Van Dusen and I thought it might be useful to switch orders since he was at the Department before I was and that would be putting us in chronological order and I think it would make it a little bit easier to follow.

Senator **Graham**. Mr. Van Dusen.

STATEMENT OF RICHARD VAN DUSEN, FORMER UNDER SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT; CHAIRMAN, DICKINSON, WRIGHT, MOON, VAN DUSEN, & FREEMAN, DETROIT, MI

Mr. **Van Dusen**. Thank you, Mr. Chairman.

As you indicated, from 1969–72, I served as the Under Secretary. Let me start with a disclaimer:

I left HUD in December 1972 and I've had very little contact with the Department since then.

Your letter of invitation indicated that you would like my thoughts on how the scandal developed. In that respect, I'm afraid I'm not going to be very helpful. Most of what I know about that I've read in the New York Times.

However, your invitation also expressed your subcommittee's interest in the mission, management, and organization of HUD programs and my observations on the improvement of HUD's internal procedures.

I am pleased to share with you some thoughts on those topics.

During our tenure in the Department, we viewed the Department's mission as having three basic elements:

First, stimulation of the production and rehabilitation of quality housing to the end that every American family can have a decent home.

Second, encouragement of the creation of desirable living environments, both physical and social.

And, third, strengthening the institutional capability of States and local units of government so they can serve their constituents more effectively.

HUD is a complex Department. It doesn't build houses or plan cities or otherwise act directly to fulfill its mission. HUD is essentially a grant-making agency providing a very broad range of financial assistance to a considerable variety of public and private organizations in hundreds of communities throughout the Nation. Its role, responsibilities and authority are derived from dozens of statutes and dozens more statutes, and executive orders impose constraints, limits, and burdens on its activities.

Success in the achievement of HUD's objectives depends on the performance of others over which it exercises limited control. And HUD is vulnerable to their failures and defaults.

That's one reason why during Secretary Romney's tenure we established the Office of Inspector General of the Department, which has the audit and investigative responsibility.

HUD is not an easy Department to manage. When it became a Cabinet Department in 1965, it pulled together a group of formerly independent agencies, each with its own program-oriented bureaucracy. There was considerable resistance to departmental integration.

As late as 1969, a call to the Department's Personnel Office seeking a file brought the response:

"He doesn't work for HUD. He's with the FHA."

Thus, a key step which we undertook was consolidation and functional organization of the Department so that we could deal with our urban constituencies from a departmental perspective rather than a collection of narrow programmatic perspectives.

During the period when Secretary Romney and I were at HUD, we also undertook to move the authority to commit HUD's resources to field offices close to the communities they served. And we moved that authority well beyond the regional offices to the area offices and FHA offices. We recognized that such decentralization required—and this is responsive to your question, I think, Senator Bryan—the adoption and publication and communication of clear policies and program guidelines and project selection systems.

Those policies and systems were necessary to achieve objective, nationally consistent administration of complex programs.

Furthermore, without such project selection systems, the Department was free to make its grants or other commitments of assistance based on the whim or caprice of the area office director or, worse yet, on raw political considerations.

Sound, functional organization and decentralized decisionmaking using clearly communicated guidelines and project selection systems are by no means the only keys to successful administration of HUD, and I hope there may be an opportunity in response to your questions to comment on other aspects of HUD's activities.

Let me just interject at this point to Senator Bryan that your question about the structure of the Department and the Organization Act prompted me to recall one considerable advantage that the Secretary of HUD enjoys under the Department Organization Act. That is, it gives him considerable flexibility in the use of the Assistant Secretaries, who are made available to him by number, but not by function. And it also gives the Secretary considerable flexibility in dispersing authority throughout the Department so that it can be effectively decentralized.

That is not typical of departmental organization statutes and it is one considerable benefit of the HUD statute which I would not want to see changed.

Thank you.

Senator GRAHAM. Thank you, Mr. Van Dusen.

[The prepared statement of Richard C. Van Dusen follows:]

OPENING STATEMENT
OF
RICHARD C. VAN DUSEN
CHAIRMAN, DICKINSON, WRIGHT, MOON, VAN DUSEN & FREEMAN
DETROIT
and UNDER SECRETARY OF HOUSING AND URBAN DEVELOPMENT,
1969-1972

Mr. Chairman, I am Richard Van Dusen. From 1969 through 1972 I served as the Under Secretary of H.U.D. I am here in response to your invitation.

First, a disclaimer. I left HUD in December of 1972, and I've had very little contact with the Department since then. Your letter of invitation indicated that you would like my "thoughts on how this scandal developed". In that respect, I'm afraid I'm not going to be very helpful. Most of what I know about that subject I've read in the New York Times.

However, your invitation also expressed your Subcommittee's interest in the "mission, management and organization of HUD programs" and my "observations on the improvement of HUD internal procedures". I'm pleased to share with you some thoughts on these topics.

During my tenure in the Department we viewed its mission as having three basic elements:

-- First, stimulation of the production and rehabilitation of quality housing, to the end that every American family can have a decent home.
-- Second, encouragement of the creation of desirable living environments, both physical and social.
-- Third, strengthening the institutional capability of states and local units of government, so that they can serve their constituents more effectively.

HUD is a complex department. It doesn't build houses or plan cities or otherwise act directly to fulfill its mission. HUD is essentially a grant-making agency, providing a broad range of financial assistance to a considerable variety of public and private organizations in hundreds of communities throughout the nation. Its role, responsibilities and authority are derived from dozens of statutes, and dozens more statutes and executive orders impose constraints, limits and burdens on its activities. Success in the achievement of HUD's objectives depends on the performance of others over which it exercises limited control, and HUD is vulnerable to their failures and defaults. That's one reason why during Secretary Romney's tenure we established the office of Inspector General in HUD.

HUD is not an easy department to manage. When it became a cabinet department in 1965 it pulled together a group of formerly independent agencies, each with its own program-oriented bureaucracy. There was considerable resistance to departmental integration. As late as 1969 a call to the Department's personnel office seeking a file brought the response "He doesn't work for HUD, he's with the FHA". Thus, a key step which we undertook was consolidation and functional organization of the department, so that we could deal with our urban constituencies from a departmental perspective, not just a collection of narrow programmatic perspectives.

During the period when Secretary Romney and I were at HUD we also undertook to move the authority to commit HUD's resources to field offices close to the communities they served. We recognized that such decentralization required the adoption, publication and communication of clear policies, program guidelines and project selection systems. Such policies and systems were necessary to achieve nationally consistent administration of complex programs. Furthermore, without such project selection systems, the Department could make its grants or other commitments of assistance based on the whim or caprice of the Area Office Director, or on raw political considerations.

Sound functional organization and decentralized decision-making, using clearly communicated guidelines and project selection systems are by no means the only keys to successful administration of HUD. I hope there may be opportunities, in response to your questions, to comment on other aspects of HUD's activities. I've tried to respect your 5-minute limit on opening comments, and I'll be pleased to try to answer your questions.

STATEMENT OF JOHN RHINELANDER, FORMER UNDER SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT; PARTNER, SHAW, PITTMAN, POTTS & TROWBRIDGE, WASHINGTON, DC

Mr. Rhinelander. Mr. Chairman, my last role in Government was at HUD where I was Under Secretary to Carla Hills. I have not, as is also the case with Dick Van Dusen, stayed close to HUD since that point in time. But, what strikes me listening to the other witnesses today is the similarity of many of the comments that we're making. We served at different times, we had to deal with different problems, but I suspect we have all learned a lot in common over these past 20 or 30 years.

In my case, I arrived at the Department shortly after Carla Hills. The principal objective we had was to implement the 1974 act. Among other things, it had the first block grant program. It took an enormous amount of effort to try to get that program successfully implemented. We had the housing assistance plans. We had Section 8, new and existing.

We have gone full cycle since that point in time. But those were the principal assignments we had. We also had a property disposition challenge, which I suspect is the case of everyone who has served at that Department.

In our case, the inspector general had not yet been set up by statute, but Secretary Hills and I met with the inspector general at least on a weekly basis. And if he had anything he wanted to bring in, he would come in and bring it to our immediate attention.

I don't think there is any alternative but close, hands-on management of the Department. It is a very complex Department. I know there are questions already about the organization of it. I think good management and good people are much more important than the actual structure. A management consultant would come in with five different alternatives. The Department has been reorganized many, many times. It would be disruptive to do so again.

It's the quality of the people and the length of time that those people serve in the Department which is really going to be the key to success rather than reorganizing.

I have half a dozen points in my prepared statement. I will emphasize a few.

HUD is a complex Department. It has many different programs. I believe there are now 47 insurance programs. As you look forward, and I don't have the intimate details now, it's important to ask how we might make the programs more efficient.

There's a tendency in this town, particularly evident to me from my earlier days at HEW, to create programs and always leave them on the books. We have a lot of half-funded programs with objectives which can never fully be met. I think it's important to go back and look to restructure as we try to move forward.

Again, as I think it's probably been true in all the years I've been in Washington, we are in a budget crisis. HUD will never get the funds to fully fund all the programs which it is ostensibly in charge of.

There's talk in town now of a peace dividend, which will be much smaller and longer in coming than many people think will be the case. We have to recognize that much of the success of the program that we are interested in is going to come from the private sector. It is important to get the private sector in better shape by getting the Federal budget down, getting deficits down. Increasing savings is as important as the programs which are, in fact, under HUD's responsibility.

In terms of looking at the past 8 years, I don't want to comment other than to say that in government generally, of which HUD is part, getting good people is perhaps the single most important thing that can be done.

Comparing the situation in Washington to the time when I first came to town, there is no doubt that it is more difficult to get good people. It is even more difficult to keep them for very long. The real challenge to everyone is to try and improve the quality of the public servants and try to keep them in place longer.

I think the average tenure across the Government now is 18 months or less at the Assistant Secretary level. There is no institution that can be well-managed over time if that's the kind of tenure you have at what is the critical level.

With respect to the problems of fraud and abuse at HUD, I think we need to recognize that really there are two kinds of things that we have to be concerned about.

One is the private sector dealing with the Government.

And the other is the Government officials themselves.

A lot can be done to reduce the problems. The current Secretary Jack Kemp and his group have come up with a series of proposals which is going to improve the situation significantly. We have to recognize, of course, that you can't do away with fraud and abuse entirely. That's why we have to set up barriers, and be responsive.

I'd like to compliment you all. It's very easy in Washington to jump on the Government and criticize it. What we are seeing here today is looking for constructive suggestions on how to deal with the problems of Government. That's terribly important.

Just a last point. In the final analysis, at that Department, good leadership is indispensable. You have in Secretary Kemp right now and his Under Secretary a combination that combines both experience and enthusiasm. People are going to have to work with them because it's not an easy Department to deal with. But I think at least we have a good basis to do so.

[The prepared statement of John B. Rhinelander follows:]

Statement of John B. Rhinelander
Under Secretary of HUD (1975-77)
Before the HUD/Mod Rehab Investigation Subcommittee
Senate Committee on Banking, Housing and Urban Affairs
January 30, 1990

Mr. Chairman, Members of the Subcommittee:

My name is John B. Rhinelander. I have been a partner of the Shaw, Pittman, Potts & Trowbridge law firm of Washington, D.C., since 1977. My firm has an active and diversified practice. We do little direct representation before HUD, however, I am personally handling one HUD matter. I am a member of the Comptroller General's Consultant's Panel which meets twice a year with Chuck Bowsher and members of the GAO staff.

Between 1966 and 1977 I served in the Departments of Defense, Commerce and State; on the SALT I delegation; and then in the Department of HEW and HUD. My last positions were General Counsel at HEW to Caspar Weinberger and Frank Carlucci, and then Under Secretary to Carla Hills at HUD. I left public office in January 1977 at the close of the Ford Administration.

While each of us on the panel this morning was previously associated with HUD, the challenges we faced during our tours were probably quite different. In my case, our basic challenge was to implement the previously enacted 1974 Act, with its block grants, housing assistance plans (HAPs), and Section 8 new and existing housing programs. There was a significant property disposition challenge, which we may find is a common denominator to all our experiences. Two of the management tools that we used were a goals management system -- a sophisticated MBO tuned to the needs of the Department at that time -- and a regulations office which sought to coordinate and expedite the regulations process. Secretary Hills met weekly with the IG. All in all, I believe we had a hands-on management appropriate then and now.

In addressing the mission, management and organization of HUD programs in today's world, I would stress the following factors:

1. HUD has a great many, very diverse insurance, grant and regulatory programs, but has only a small part of the federal governments responsibilities in the housing and development sectors. If we were starting from scratch, HUD would have less but better focused programs, assuming Congress spoke with a single coherent voice.

2. In a time of budget crisis, which represents the work I have known since coming to Washington in 1966, HUD will not get the resources to fully fund its program responsibilities. The "peace dividend", which many are carving up in expectation, will be much smaller and later in time than generally perceived. The greatest national needs, which will also benefit housing, are reduced federal deficits, increased savings, and lower interest rates.

3. There is no substitute for able and dedicated leadership of HUD. This is much more important than the organization of the Department itself. I am concerned whether the federal government -- and not just HUD -- can recruit and hold the skilled people it needs. I fear HUD has lost much of its historical memory and many of its experienced hands.

4. HUD fraud and abuse seems to be of two basic kinds. The first involves people doing business with HUD, which could be minimized but not eliminated with well-defined programs, oversight, internal controls and management information systems. The second involves HUD personnel

interacting with the public in allocating scarce government resources, which can also be minimized but not eliminated. While focusing today on HUD, we should recall that the private sector is not free of failures and corruption. In part, we are talking about the human condition.

5. The most troubling aspect of recent developments is that none of the oversight mechanisms identified the HUD problems at an early stage. There were many IG and GAO reports, but none of them captured the big picture. The OMB function, which includes management, failed. Perhaps most telling of all, Congressional oversight, which represents the checks and balances of our Constitutional system, was apparently totally ineffective. This may reflect, in part, the fact that constituent service seems to have become dominant during the twenty-five years I have been in town.

6. At present, HUD has a Secretary who brings concern, enthusiasm and respect to his position and an Under Secretary who is highly experienced in government. Given time and assuming the country does not have a national recession which would compound present problems many fold, they appear determined to bring the Department the kind of leadership that it needs. They may well succeed. However, they will need the constructive support from all quarter to do so.

'Robin HUD' Pleads Guilty To Embezzlement Charge

By Lisa Leff
Washington Post Staff Writer

BALTIMORE, Jan. 29—Marilyn L. Harrell, the Maryland escrow agent who became a national symbol of lax management at the U.S. Department of Housing and Urban Development last year, pleaded guilty today to embezzling millions of dollars from the federal agency.

On the day her trial in U.S. District Court here was to begin, Harrell, 46, whose chatty accounts of how she stole from the government to aid the poor earned her the nickname "Robin HUD," also admitted that she knowingly underreported her income on her 1987 tax forms.

The two pleas were part of a complex agreement between Harrell and the U.S. Attorney's Office, hammered out during the last few weeks, in which prosecutors promised to drop four other charges—ranging from lying to investigators to falsifying information on a loan application—in exchange for Harrell's cooperation, said Assistant U.S. Attorney Gary P. Jordan.

Although the Prince George's County resident has talked publicly and testified before Congress about how she skimmed money for three years from the sales of foreclosed properties she handled for HUD, she said she decided to enter six not-guilty pleas in December on the

See HUD, A5, Col. 1

Maryland's 'Robin HUD' Pleads Guilty To Embezzlement Charge, Tax Violation

HUD, From A1

advice of her attorney, public defender Anthony Gallagher. But before today's hearing she said she had decided to plead guilty because she liked the terms of the plea agreement, adding that she had hoped to spare the government the expense of a long court trial and the poor people on whom she allegedly bestowed the embezzled money the stress of having to testify.

"What's the point of being deceitful? I'm not going to hide what I did," she said.

Harrell appeared calm and self-assured in court, occasionally smiling at the crowd seated behind her, as Judge Herbert F. Murray questioned her to make sure she understood the ramifications of her pleas.

Afterward, Harrell said she did not fear going to federal prison because convicts "are the type of people I was trying to help." She said the source of her troubles was an accounting mistake she made in one of her escrow accounts. Once she realized that she was going to get caught for the mistake, she said, she deliberately exacerbated it by taking more money.

"I figured I was history and would help as many people as I could before I went down," she said, adding that she would not handle her affairs the same way again if given the chance.

Jordan said the government had agreed to take Harrell's voluntary plea into account when recommending a penalty at sentencing, which Murray set for April 20. Harrell faces a maximum of 13 years in prison and a $500,100 fine, but U.S. Attorney Breckinridge L. Willcox said he thinks she will receive a three- or four-year prison term.

Willcox said the ultimate sentence depends in part on how much money the judge believes Harrell stole. The defense says the total is $4.5 million, while HUD investigators' most recent accounting puts the figure at $6 million, he said.

At today's hearing, defense attorney Gallagher disputed several more of Jordan's assertions about his client, arguing, for instance, that Harrell did not try to conceal her business records from her employees. He also denied allegations that Harrell had tried to buy the silence of one suspicious worker by giving her a car.

Willcox rejected Harrell's claim that her scheme grew out of a sincere desire to help people living in poverty. "We know how she spent it . . . . When all the evidence is in, my assertion that she was her own biggest charity will come out as fact," he said.

ASSOCIATED PRESS

Harrell, left, hugs Charlotte Chepaitis, who runs a shelter for the homeless with money she said Harrell gave her.

According to Willcox, Harrell's actions represent the single largest theft of government money in U.S. history. Yet the public's chances of recovering the losses are poor because Harrell does not appear able to restitution, Willcox said. After seizing Harrell's house, car, businesses and other assets, HUD has recovered "significantly less" than $1 million, he said.

THE WASHINGTON POST

HIGHLIGHTS OF THE FISCAL 1991 BUDGET

Housing and Urban Development

Officials at the Department of Housing and Urban Development, which underwent deep budget cuts during the Reagan administration, hailed its $23.7 billion budget—a $5.3 billion increase over the current level—as proof that the department has regained respectability in the Bush administration.

"That 29 percent increase is good news," said HUD Undersecretary Alfred A. DelliBovi. But some interest groups charged that the news was not good and that the largest increases for some ongoing programs indicated that other programs had been cut.

"It's a case of robbing Peter to pay Paul," said Richard Nelson, executive director of the National Association of Housing and Redevelopment Officials. "Through smoke and mirrors, they're trying to indicate that they are giving more assistance, and they're not."

For example, Nelson said, HUD eliminated its $5 million "congregate housing program," which funded group living arrangements among the elderly.

The HUD budget attempts to address some areas in which the department has been sharply criticized. It boosts funding for homelessness programs by 66 percent to $150 million and adds $33.5 million to help HUD better manage 77 computer financial systems that now cannot communicate with one another.

As expected, the budget includes $1.2 billion to help finance the president's HOPE (Homeownership and Opportunity for People Everywhere) program, to provide grants and matching funds for housing initiatives.

The administration is proposing to require local housing authorities to develop detailed plans for helping low-income families climb "the ladder of opportunity" out of poverty. Agencies that lack such plans will be denied HUD funds under the proposal.

Senator **GRAHAM**. Thank you, sir.

Mr. Philip Brownstein.

STATEMENT OF PHILIP BROWNSTEIN, FORMER FEDERAL HOUSING COMMISSIONER; SENIOR PARTNER, BROWNSTEIN, ZEIDMAN & SCHOMER; WASHINGTON, DC

Mr. **BROWNSTEIN**. We'll now go back in time, Mr. Chairman. I was there with Secretaries Weaver and Wood, as you have indicated, and briefly with Secretary Romney and Dick Van Dusen. Before that, I was the Chief Benefits Director for the Veterans Administration and was in government for over 30 years.

Departing also from my prepared text to comment a bit on structure. When we were at HUD, FHA was pretty much of a total entity, a complete unit. And as Dick Van Dusen said, someone suggested that a person didn't work for HUD, they worked for FHA.

That, of course, had some negative influences, but it also has some positive results. I think one of the problems that surfaced after we left was the desire or the vigor with which an effort was made to get FHA, "integrated into the Department."

There was, in my opinion, an excess of blending all elements, including FHA into a single entity. There was a loss of communication and span of control. And I'm delighted that Secretary Kemp is moving away somewhat from that structure and is reestablishing a comptroller in the Federal Housing Administration. That all got blended into HUD after we left and that was a mistake; it shouldn't have been done, in my opinion.

I can elaborate on that later if the committee so desires, but I would like also to talk about the mission of the Department. One of the principal missions is in addressing the housing needs for the disadvantaged. In doing that, virtually every possible mechanism has been enacted and implemented.

Trying to find an ideal solution to this, we saw it have its beginning in 1937 with the Public Housing Program under which the Government built and owned the projects.

This was followed by the direct Government loan at a below market interest rate, Government purchase of below market interest rate loans, subsidizing interest rates on mortgages held by private investors, subsidizing projects through rental payments on behalf of tenants; subsidizing projects through tenant rental assistance paid to owners, and subsidized development costs.

All these have been tried, just about every mechanism you can think of. They all had a very significant role in adding to the supply of housing for the needy. But, they all also suffered a common weakness:

They are costly.

And I must tell this committee that there is no magical formula for otherwise dealing with housing assistance for the needy. It's going to be costly.

For all intents and purposes, all housing production programs responding to lower income needs have been terminated. The program we have today involves housing vouchers heralded as less costly than constructing new units; and, indeed, it is where it works.

Under this program, the prospective low-income tenant is given the voucher and is told to go find a suitable unit. This is fine where there's housing available. But, where moderate cost rental units are in short supply, and this is true in virtually every urban area, the voucher is virtually useless. Without some program designed to increase the supply of low income housing, the fate of those needing housing assistance, temporary shelter and a range of social services will worsen.

The bills for that loss to our economy will come due and its human and economic costs will dwarf any price tag attached to Federal housing efforts.

Today, we face a potential loss of perhaps 40 percent of the low income housing inventory by the year 2000 as subsidies expire and mortgages are prepaid. There is nothing in place to replace these units let alone adding to the supply in the areas of shortage.

It is critical today that some program be instituted and funded which will result in new housing units being put in place by means of new construction, or substantial rehabilitation.

After 8 years of a moribund attitude at HUD, when the primary objective was to close down the Department's activities, it's encouraging to hear Secretary Kemp and other HUD officials express concerns about pressing housing issues and recognizing the need for dealing with them.

So far, however, we have seen several announcements of program terminations but little evidence of forward progress designed to meet the need for housing.

The most recent HUD announcement, the termination of the coinsurance program, with nothing else in place and operating as a substitute, is particularly troublesome. The replacement program for delegated underwriting, while announced, is a long way from being operational.

Hopefully, there will soon be some signals that housing is viewed as a priority by the administration.

Only when it does will something meaningful emerge that begins to address our Nation's critical needs.

Thank you.

[The prepared statement of Philip N. Brownstein follows:]

STATEMENT OF

PHILIP N. BROWNSTEIN
PARTNER, BROWNSTEIN ZEIDMAN AND SCHOMER,
FORMER COMMISSIONER, FEDERAL HOUSING
ADMINISTRATION/ASSISTANT SECRETARY
FOR MORTGAGE CREDIT

UNITED STATES SENATE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS

SUBCOMMITTEE ON HUD/MOD REHAB INVESTIGATIVE SUBCOMMITTEE

January 30, 1990

Mr. Chairman and members of the Sub-Committee. My name is Philip Brownstein. I was Commissioner of the Federal Housing Administration and Assistant Secretary for Mortgage Credit under Presidents Kennedy and Johnson and before that was Chief Benefits Director of the Veterans Administration.

While it is not my intention to do very much recycling, some historical perspective may do more than provide opportunities for nostalgia or reminiscences for those of us who have been toiling in the housing vineyards for a long time. As with science, the experiments of the past at least provide notice that we don't need to take a particular course again. On the reverse side, the record of the experiment also may suggest certain elements are worth retaining -- and certain components are critical.

The other capacity history gives us is the ability to question the visions of the past and their relevance for the future.

There is, as has frequently been reported, "an ominous trend to greater inequality" with the have-nots increasing in number and the middle class shrinking. And nowhere has this economic squeeze been felt more than in the inability of growing numbers to find affordable shelter. This has resulted in vast increases in the number of homeless and an alarming number of families with children now included in the homeless statistics. And the dream for home ownership has disappeared for many and faded for others. In fact, in the past decade the number of families owning their homes has declined by about 2%.

During the 80's we saw a continuing retrenchment and withdrawal of federal assistance and involvement in the field of housing; today what has trickled down to those at the bottom of our society has fallen far short of the number of needy added to the rolls.

The Federal assistance which has been provided over the years clearly has had its imperfections. But there have also been significant pluses. Probably the most significant ingredient in creating a nation of homeowners was the assistance provided by the mortgage insurance programs of the Federal Housing Administration.

In addressing the housing needs of the nation's disadvantaged, virtually every possible mechanism has been enacted and implemented in an effort to find the ideal solution for adding to the housing stock. We saw its beginning in 1937, with the public housing program, under which the government built and owned the projects. This was followed by the direct government loan at a below market interest rate (Sec. 202 housing for the elderly); the government purchase of below market interest rate loans (Sec. 221(d)(3)); subsidizing interest rates on mortgages held by private investors (Sections

235 and 236); subsidizing projects through rental payments on behalf of tenants (Sec. 221(d)(3) rent supplement); subsidizing projects through tenant rental assistance paid to owners (Section 8); and subsidized development costs (HODAG).

All of these programs had a significant role in adding to the supply of housing for the needy. But they all also suffered from a common weakness: They are costly. And I must tell you there is no magical formula for otherwise dealing with housing assistance for the needy.

For all intents and purposes all housing production programs responding to lower income needs have been terminated. The program we have today involves housing vouchers, heralded as less costly than constructing new units. And indeed it is -- where it works. Under this program the prospective low-income tenant is given a voucher and is told to go find a suitable unit. And this is fine where there are housing units available. But where moderate cost rental units are in short supply, as is true in most major urban areas, the voucher is useless. Without some program designed to increase the supply of low-income housing the fate of those needing housing assistance, temporary shelter and a range of social services will worsen. The bills for that loss to our economy will come due; and its human and economic cost will dwarf any price tag attached to federal housing efforts.

Today we face a potential loss of perhaps over 40 percent of the low income housing inventory by the year 2000 as subsidies expire and mortgages are prepaid. There is nothing in place to replace these units, let alone adding to the supply in areas of shortage. It is critical today that some program be instituted and funded which will result in new units being put in place by means of new construction or substantial rehabilitation.

After eight years of a moribund attitude at HUD -- when the primary objective was to close down the Department's activities -- it is encouraging to hear Secretary Kemp and other HUD officials express concerns about pressing housing issues and recognizing a need for dealing with them. So far, however, we have seen several announcements of program terminations but little evidence of forward progress designed to meet the need for housing.

The most recent HUD announcement, the termination of the co-insurance program, with nothing else in place and operating as a substitute, is particularly troublesome. The replacement program for delegated underwriting, while announced, is a long way from being operational.

Hopefully there will soon be some signal that housing is viewed as a priority by the Administration. Only when it does will something meaningful emerge that begins to address our nation's critical housing needs.

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Senator **Graham**. Thank you, Mr. Brownstein.

I was struck by the image of Senator Mack's statement of the young boy in the housing project in Melbourne asking the question:

Will he have some alternative to see the world as other than that which is immediately around him?

What is your comment as to the prospects if the current circumstances, and you've just seen the release of a new President's budget in which I think it was instructive how little attention either there or in the press today was given to the housing component of that budget.

What are your assessments of the prospects of that 2-year old boy before he reaches high school being able to see a better vision of the world?

Mr. **Weaver**. Very low. I read this morning, in the Wall Street Journal, the direction the administration is moving and the President is moving. I didn't read a word about housing. And it's gotten such a low interest now because there's been so much happening that people have been misled to think you can't do anything about this problem; it's so big, you just can't touch it.

Well, I think it's a very, very vital problem. One of the things that has disturbed me in particular was, in 1968, in the Omnibus Housing bill, the Housing and Urban Development bill, we initiated a rehabilitation of existing public housing. Some of it was almost 40 years old then. That has been cut out completely. That's just bad economics because when it's cut out, then you are going to have what you had to do in St. Louis, blowing up the whole project. That's going to cost a whale of a lot of money if you're going to do anything about it.

So I think we are now in a situation where there is danger that we may be led to believe that you do nothing because, if you do it, it's going to be badly done.

I'd like to reiterate and support the statements that were made recently, and that is the fact that:

You cannot minimize the quality of the people, particularly at the Assistant Secretary level.

And I also would report for the record that, in the 3 years when Phil and Bob and I were there, there wasn't a single assistant secretary who left. So you get good people, give them some authority and they become involved in the program. That's the way you keep them.

Mr. **Wood**. Not to dissent, boss——

[Laughter.]

Anyway, on that, the hot button now is I think Senator Mack's picture that he indicates, plus homeless. It seems to me that the condition and the plight of the homeless is probably the strategic takeover point for housing for the poor. What's disturbed me is that, as you look at New York City, Boston and some of the other efforts to deal with housing for the homeless, they are enormously temporary both in quantity and quality.

But I do think that is probably one of the directions and ways we can move.

Mr. **Weaver**. Getting back to what Phil was talking about on housing allowances and their not working where the supply is low, in New York City apparently, according to the papers, the regional office in New York said:

"Look, we've got these supplements, section 8 grants, and we've got to use them right away."

So they looked around and the only place they could use them in New York City was in the Mitchell-Lama moderate-income housing, a subsidized program. Thus HUD subsidies were added to existing ones. Data for 113 households, said to be representative of the 600 involved, indicated that about one-third paid less than $20 a month shelter rent, and 55 percent were paying $40 or less.

This is just bad economics, bad administration, bad policy.

Senator GRAHAM. Mr. Brownstein.

Mr. BROWNSTEIN. The 2-year old boy in Melbourne, Senator Mack, may be somewhat better off on the likelihood of breaking out of Melbourne if the family decides to go elsewhere in Florida because I think that there are some areas in Florida where there is some moderate income housing and where perhaps housing vouchers or some existing subsidy could be helpful. That child has a better chance, I think, than one in Washington or one in New York or one in Philadelphia.

Senator GRAHAM. My time is almost up.

One thing that strikes me in each of you is the commitment to public service. Mr. Van Dusen indicated that since his period of service, that he has been at some distance from the Department. That experience is quite in contrast to some of the recent persons who served in your position who used their experience in Government for substantial private gain.

Two questions. One, what contributed to that change in orientation from seeing public office as a trust to seeing public office as an opportunity for gain?

Second, this committee has the responsibility for confirming most of the people who served in these positions.

Any recommendations to us in that confirmation process as to how we might probe what the likely orientation, trust or private gain of a person who is submitted for one of these important positions carries?

Mr. VAN DUSEN. Senator, let me say that I was certainly as disappointed as you all have been in the public reports of some of the involvement of former HUD officials. I would like to make the point that one exception to that is former Secretary Carla Hills, who was performing, in my view, simply as a lawyer and did so quite responsibly. I happened to watch her appearance on C-Span. I've known Carla for a long time, and I think she exemplifies the finest in public service. Unfortunately, I don't know if that can be said of some of the others.

From the standpoint of your responsibilities in confirming Presidential appointees, I think you have the obligation to do the best you can in terms of finding out about the prior experience and prior record. You have to have the chance to look them in the eye. Then you have to make your own judgments.

There's no formula I can give you for spotting a bad apple early on.

Senator GRAHAM. Does anyone else care to comment on that question?

Mr. Rhinelander; then Mr. Brownstein.

Mr. **Rhinelander**. Mr. Chairman, I came to Washington in 1966. Those of us who came at that point in time looked at ourselves and we were generally looked at as public servants. Obviously, we weren't perfect. We didn't have all the answers. We made mistakes.

But there has been an enormous change. You come in. People wonder why you come. For 12 years, there has been bipartisan—President Carter and President Reagan—dumping on the Federal Civil Service, dumping on public service. It was really kind of the order of the day. It made service unpopular.

The pay situation, we're all familiar with that problem. I tell the young lawyers in my law firm that when I first got out of law school and clerked at the Supreme Court, I was paid exactly the same amount as a starting lawyer on Wall Street. They found that totally amazing.

The pay situation makes it difficult. It makes it difficult to keep people in very long, key people.

In terms of the confirmation process, obviously, you have to react to names that are put forward. I will say this. While I haven't served in the last 12 years, the detail of public disclosure of private lives discourages an awful lot of people that I know from serving in government, which I think is unfortunate.

The level of detail which you as a committee member see on the financial resources and things of that kind discourages good people from coming forward. I'm not sure that's the way to go and I would urge the committee to think that over. This is of course a governmentwide problem.

But I think one of the problems is simply the whole concept of public service has changed radically over the past 20 years and you're not getting the people who are willing to come forward as they were 20 or 30 years ago.

Mr. **Van Dusen**. Mr. Chairman, I'd like to endorse Mr. Rhinelander's remarks in that respect. But I'd also like to recall for you a comment which Phil Brownstein made when I first met him in 1969.

He said at that point, as he was ending a very long and distinguished career in Government, that people frequently asked him:

"Phil, how could you have stood the frustration of government service all of this time?"

Phil said:

"Well, I usually respond. Every once in a while, something goes right." [Laughter.]

Which I think is the case. And it is probably important to look at the things that go right as well as the things that go wrong.

Senator **Graham**. Yes, Mr. Brownstein.

Mr. **Brownstein**. Let me endorse what John Rhinelander said, particularly on the attitude of us against them in the Carter and Reagan administrations. They both ran against Washington. They both forgot that, after they got here, they were the establishment. They continued the Us versus Them attitude.

It's difficult to speculate on what it is precisely that went wrong in HUD and why all these things happened. But I think it's important to bear in mind that the people who went into HUD went with a specific purpose. They were supposed to terminate programs. They weren't there for the purpose of fostering programs and trying to carry out a mission of HUD.

If there was a mission, it was to eliminate HUD.

With that overall general attitude, I don't think it's hard to reason to the result that ultimately occurred. If you have people that don't believe in these things to begin with, then I guess it's more likely certainly that you're going to have this kind of a result.

Senator **Graham**. Thank you very much. I appreciate your comments and I apologize to my colleagues for having gone over my time limit.

Senator Mack.

Senator **Mack**. Thank you.

Let me just mention a couple of numbers, since no one seems to have focused in the press with respect to housing anyway on the President's Budget.

The 1989 actual budget authority was $14 billion; 1990 estimate about $18.3 billion. And under the President's request $23.7 billion budget authority.

One of the stories covering the housing issue indicated additional Federal funding for subsidized housing would allow for an increase of more than 82,000 units. I don't mean to imply that that's going to solve the problem. But I think there's some indication on the part of the President and on the part of Secretary Kemp that greater commitment needs to be made.

You know, there are so many issues that you all have touched on and there's no way we're going to be able to get to each one of them. But I think, Mr. Brownstein, it was you that mentioned that whether we were going to make a commitment to housing in this country or set the priorities once again for housing—maybe it was Secretary Weaver. I'm not sure.

One of the things that struck me during this past year, and this is my first year—now my eighth year in the Congress—to be involved on a committee that deals directly with housing. So a lot of this is new to me.

As I have thought this through, it seems to me that there had been lots of things that we had done in various parts of the Government that, in fact, have had an impact on housing. It's not just what we do with respect to HUD.

And what's going through my mind is someone mentioned that—I think someone mentioned—the 1968 tax law took away one of the three incentives.

Mr. **Brownstein**. 1986.

Senator **Mack**. You did say 1968, but you meant 1986.

Mr. **Brownstein**. I'm sorry. It was 1986.

Senator **Mack**. But there have been changes both in tax law—we made a decision years ago to, in essence, deregulate interest rates, which could probably be argued on both sides as to whether they really had an impact long-term with respect to the cost of housing.

There were issues about zoning regulations have increased the cost of housing, that environmental regulations have increased the cost of housing. And, independently, all of those have had major significant impacts.

I would be interested maybe in your reaction as to should we be, when we're addressing the question of housing, as someone indicated in their comments, that that 26 million units, roughly, 18 million of that or so were low to moderate income as opposed to, say, 6 million or so that was for low income?

We have to look at the whole spectrum, or we should be addressing the whole spectrum.

Mr. **Weaver**. I think you've hit on a very sensitive point. One of the things that the authorizing legislation said was that we should assist the President in bringing these other agencies which have some impact, sometimes a very serious impact on housing, together. That was something that never happened.

You've got a problem, the structure of Government as such. If an agency fixes interest rates and its main concern is to stop inflation, it's almost impossible to get it to look at the housing aspect of this because they have a vision looking at the whole economy and looking at certain aspects of it. So that it's almost impossible to conceive of getting the type of thing that we all would like to have when we started with the legislation for HUD, for example.

A lot of the purists said:

You should transfer every agency that has anything to do with housing in HUD.

I said: For God's sake, don't try it because I saw what happened when you got into these intergovernmental rivalries and got into these turf battles. And if we ever tried to do that, we never would have had HUD. I can say that, too.

So that I think this is one of the things like death and taxes. You have to live with it. What you do is you nibble. For example, on interest rates, what we were able to do, Phil and I, when he was with the Veterans Administration, weren't able to set the interest rates. But, if the interest rates were going up, we were able to let them get up before we put the housing interest rates up in VA and FHA.

It's that type of marginal thing that you can do, but I don't think you can make the basic onslaught in bringing these agencies and departments to look at everything from the point of view of housing, unless you want to change the structures of committees.

Senator **Mack**. I guess really I raised that because I agree with you. I don't think there's any way—in fact, it brings to mind again the comment about the conflict between Treasury and HUD. I don't think there's any way, in fact, to bring all of those together. I raised it from the standpoint of saying that there is really more going on out there in this society of ours that affects housing other than what we are going to decide as to how HUD should be structured and what programs should be funded, and what shouldn't be funded.

There are things that are happening out there that I think significantly impacted the cost of housing.

To get back to a point that was raised, there are two types of programs, in essence. The supply side and the demand side. It takes a combination of both.

Do you sense that there is any problem out there in the allocation of where we ought to be placing the emphasis, let's say, on the supply side? And where we ought to be placing the emphasis on the demand side?

Mr. **Weaver**. I don't think it's been revealed yet.

Senator **Mack**. Let me just finish.

The hope is that maybe in an area like Melbourne the voucher system works very well, but in New York City, the construction is needed. I don't know. But, I'd at least be interested in how—is there something we should be looking at that kind of allocates those resources?

Mr. **Weaver**. I think the only thing we can do is to have very good economic information, to know what the housing market is like. If it's a tight housing market, then you know you're going to have to have some new construction.

If it's a loose housing market, you need less new construction. And if it's very loose, you probably don't need any. But, to have one program to deal with problems which vary so much from locality to locality, you're sure to have a vacuum and a place where it isn't covered by that one program.

I think that's as far as I'm willing to go.

Mr. **Wood**. As a point of departure now, I think it's clear to know that for the last 8 years, HUD's program budget has been the most severely impacted and reduced of any department or agency.

And, second, Phil Brownstein's reminder that by the year 2000, we will have lost 40 percent of the stock for low and moderate income housing, that means we're starting from playing catch-up ball in the beginning, going into the nineties, and we are facing deteriorating stock on top of that.

Mr. **Brownstein**. There are pretty good data, Senator Mack, on vacancy rates in various metropolitan areas in general. You can get relatively good information on that. I don't think there's any big mystery about where we have an adequate supply of housing. It would be ridiculous to go to Dallas and Houston and New Orleans and Alaska and construct new housing for poor people.

We already have an adequate supply of existing housing. All you have to do is have a mechanism there, vouchers or whatever, to get the cost of it within reach of those needing assistance.

But you also have a good many, as I indicated earlier, metropolitan areas, this being one right here, where there just is no supply of moderate-priced housing.

Senator **Graham**. I'm sorry. Mr. Rhinelander.

Mr. **Rhinelander**. Senator Mack, just to further comment on this and picking up on several comments made earlier, Phil Brownstein has said correctly that new housing is very expensive. Others have pointed out that we don't deal with an economy which is uniform across the board. You have an oversupply in some areas. You have shortages in other areas.

To deal with the most difficult problem of all, which is the necessity of housing supply for the low income, politically, it's going to be very difficult. We have never had programs which have really focused—the Government programs—on the very low income successfully.

They've been spread across the board pretty much geographically. Ten regional offices for HUD cut the pie 10 different ways effectively; you don't focus it where the need is the greatest.

Whether or not that's going to be politically possible, if you have new production programs start up, is going to be one of the real challenges. In some cases, you have an oversupply. Texas is one case right now where you don't need the supply.

You're going to have new programs available in some parts of the country, not in others, which is a very, very difficult political question to deal with.

Senator **GRAHAM**. I might just make an observation.

One of the things that we determined at our previous hearing is exactly the opposite of what you said logically should occur did occur with the Mod Rehab Program. And that is, as the program was centralized, the consequence of the money flow was toward those areas that already were overbuilt—Texas, Denver, Oklahoma are three examples.

The reason was because there were incentives in the system that made those the more profitable areas for the developers to target their attention.

I note that as an example of where the structure and the management of the program was counter to what the economics would appear and what good public policy would indicate would be proven to the stewardship of resources.

Senator Bryan.

Senator **BRYAN**. Thank you very much, Mr. Chairman.

I want to endorse an observation you made as to the quality of the witnesses who are here before us today. I must say, each of you gentlemen, serving in different periods of time in different administrations, some of you, the sense of personal pride that is reflected on your faces after your tenure, the accomplishments that you had, I find to be quite vicariously very reassuring that there are men like yourselves who have given a great deal to this program, with different political persuasions and different philosophies, I'm sure.

Let me make that observation and let me come back to you, Mr. Brownstein.

You recited a litany of half a dozen different types of subsidy programs. Let me ask you if you will refresh your memory as to those half dozen you just shared with us.

Which of those programs do you think works today, or would work today? Any of those programs that you'd say, Look, we tried it. God, we were sincere. We made a valiant effort, but it just didn't work. You don't think it will work and I wouldn't commend that to you.

And is there something that hasn't been proposed which you think may work?

I'm going to ask each of you.

Mr. **BROWNSTEIN**. I think about everything has been tried that anybody can think of, Senator Bryan. Yes, there were imperfections in these. Some of them we were responsible for had imperfections in them—the interest subsidy program, the below market interest program. Both had a glaring weakness which we didn't discover until much later. And that was that there was no built-in mechanism to deal with increased operating costs.

When the oil crisis came and the price of fuel oil skyrocketed, operating costs went way through the roof and there was not a mechanism to deal with the resultant increased rents.

What I would say is this, Senator. Section 8 worked. It's the one that the few remaining people at HUD who know anything about subsidized housing know something about.

So, if there were to be a program reinstated for construction, I think it's as good as any. It achieves the purpose. I'm talking section 8, new construction or substantial rehabilitation.

Nothing wrong with the Mod Rehab Program either except for the way it was at times administered.

But, I suggest section 8 because it's something that works. Sure, it's costly, but every one of them is costly. There's no way of avoiding that. But, since there is the familiarity with it, if there were a program reinstated, take the one that the most people know about.

Senator BRYAN. Other comments from others of you?

Mr. WEAVER. I might add to what Phil said.

When the program were provided for in the 1968 bill, Phil and I spent a lot of time up on the Hill, particularly with the Senate. And I have a record of that.

One of the things we said repeatedly is:

This and that is a costly program. It's a program of high risk and, therefore, it's costly.

I think that this has to be said and it may be politically not too advantageous. But I think, in the long run, it's much better if you tell people out in front rather than to give the impression that this isn't going to cost anybody anything. There's no such animal in housing, in my opinion, that isn't going to cost somebody something if it's subsidized.

Senator BRYAN. Mr. Van Dusen, Mr. Rhinelander, any comments that you might have as to these programs that you've wrestled with, those that you think worked, those that were terrible mistakes, recognizing that there are imperfections, as Mr. Brownstein tells us, in all of these programs? But, anything you would specifically commend to us?

Mr. VAN DUSEN. At the time I left the Department, we were looking at the supply side programs rather critically and we recognized that each of them was expensive, that interest subsidy programs in particular were inefficient in the sense that they were so laden with redtape and requirements and the overlay of environmental and affirmative action and other concerns that, by the time you built one of those units, you could have built one conventionally across the street a lot cheaper.

So you couldn't make it available to a moderate income family without laying on another subsidy to bring the rent to their range.

My own radical, simple solution would be to abolish the Department. I think you could accomplish its three major objectives by spinning off the mortgage credit insurance functions of the FHA to a private entity on the Fannie Mae model; you could take care of the principal housing needs of poor people through a form of housing allowance or income maintenance. And you could take care of the community development functions of the Department, all of which are very desirable, through a system of community development revenue-sharing and thereby eliminate the Department.

Now, I suggested that when I was in the Department and nobody paid a lot of attention to it. And I suggested it shortly after I left the Department and nobody paid a lot of attention to it. I suspect there are those in the Reagan administration who wish they had listened to that proposal because the fact is that, if you are going to have a Department on the present model with the complex programs that it administers and the enormous variety of programs it administers and the vulnerability of those programs to abuse, you have to have very active, very strong management in the Department, as we have all said earlier.

There's a thought for your committee. [Laughter.]

Mr. **Weaver**. Let me take great exception to that. In the first place, I think that there's no way that you can have housing for the disadvantaged without having some public involvement in it. There's no way that you're going to be able to get the private enterprise system to go into that area unless you give them some, as Phil pointed out, inducement, which is that they're going to get something comparable out of that effort to what they get for building for more affluent people.

There is no economic way that can happen unless you have the sort of thing that we've been having recently. When that occurs, instead of building for the people that need housing the most, you are subsidizing the people who need it the least.

That I don't think is what good public policy involves. So that it seems to me although I believe that the Reagan administration tried to abolish the Department and almost succeeded, that this is not what needs to be done, particularly when you look at what's happening in our cities today, when you look at all the problems that we have in the city. Then you're going to say, you're going to take away any hope that can be given to people to have better places to live, better places to rear their kids.

I just think that's antisocial and I think it's a very, very dangerous one. So I would certainly not agree with that.

Mr. **Rhinelander**. I would not abolish HUD. I would try and do something even more difficult, which would be to rationalize the programs within each of the various departments. For instance, HUD now has the housing voucher programs. I think there's a fundamental problem in the lower income and I would deal with it probably out of HHS.

What we were looking at my time at HEW was a welfare reform proposal, which was absolutely necessary and I would deal with that separately from housing.

Mr. **Weaver**. The answer to that is that the people in the social area, the welfare and health and welfare and education people have been in housing for a very, very long time. And you have now one of the biggest problems in housing; that is, that people on relief don't get enough housing allowance to be able to get decent housing even in a loose housing market. And that is documented.

So that I have a feeling that if you don't have some particular orientation toward housing, that you're not going to have a good housing program. And with that orientation, you don't get it either unless you have good people. But just to say we'll put it here or put it there, means that it takes a very, very second rate position.

And when you have scarce resources, those in the second rate position get less, at best.

So I don't think that is the solution to this at all.

Also, housing is more than just building a house. That goes back to the 1949 act. And a suitable environment. Whose going to find out what a suitable environment is and do something about it?

Mr. **Brownstein**. I believe, Mr. Chairman, the thing to do is to make the programs within HUD work and they can be made to work. They need commitment. They need funding.

You know, you reflect on things that happen and where priorities go. And we are now at the point where we are going to be spending probably upward of $200 billion on the savings and loan debacle.

We're going to be giving Eastern Europe some help. And, indeed, I think they're entitled to it. But, when it gets to housing for the poor, somehow it doesn't get a very high priority any more.

I think that we are going to have to realize that there are some other needs, some needy folks here, that are going to have to be attended to and it's going to cost some money. And we're going to have to find it somewhere. At least give it the same attention as is given unexpected needs.

Mr. **Wood**. I would think, if one took Dick Van Dusen's position from the perspective of organization and management common sense, there's a great deal that supports him in this, indeed, that was a debate in the establishment of the Department; the Bureau of the Budget, now OMB, really didn't see that we needed that Department.

I think, however, Secretary Weaver's comment in terms of a symbolic importance right now of saying we're not going to turn our back on the cities and saying that we're not going to leave that youngster Senator Mack spoke of within that nonsuitable environment and that we're not going to walk away from the mayors of America is an enormously powerful function that all departments and agencies take.

Though there are times I confess, Dick, that I went home and I said:

Why do I need to go back again?

Senator **Graham**. We're going to call the next panel at 11:30, which only gives us 5 minutes for any concluding questions or comments.

Senator Mack.

Senator **Mack**. Yes. The question that you raised certainly got a lot of different thoughts and stimulated discussion and I can't help but respond in the sense that I gather from the comments, Secretary Weaver, that you made that the environment is different out there today than it was—whether it's 1949 or 1968 or whatever. And I certainly sensed again by my opportunity to talk with different people who were involved in public housing, that things are really different out there.

I know that the suggestion of doing away with HUD or moving certain parts of it to other agencies really isn't going to get anywhere, but I can't help but feel it's fair to come back and say that I don't think what either one them was saying is that we ought to take away the commitment to housing or that we ought to take away the commitment to try to give people the opportunity to move forward and improve their lives.

If we can find a more effective way of doing that, we ought to search for it. Unfortunately, when Mr. Rhinelander or Mr. Van Dusen raised that, it is immediately met with the reaction that you don't care. And I think that's unfortunate.

As I say, I feel confident that their suggestions are not going to go anywhere just because of the political environment in which we debate these things.

Mr. **Weaver**. There is one thing that could be done if you want to get rid of HUD, and that is we could have a public policy to do something about unemployment and something about people who are not going to fit in the new economy that is emerging, a service economy, which requires at least a high school education.

We can do something about raising family income, about incomes for children. This you can handle. And you may do that. And maybe you wouldn't need any department. You wouldn't need any subsidies.

Senator **Mack**. Let me tell you what comes to my mind as they were discussing that. The thing that really hit me as I visited these different public housing units and talked to the individuals, because, frankly, there aren't many families out there as you and I think of families, is that way too much emphasis has been placed on the discussion about bricks and mortar and buildings. There certainly has to be the units out there for people to live in.

But, it seems like not much attention has been given to the problems that these people are dealing with that live in these units. I'm not suggesting that you ought to attempt to deal with that, but maybe it's been split and separated into too many different departments and too many different managers trying to manage their aspect of the problem.

What I saw was some people living in a very nice unit who said to me that their hope is that some day that they can finish and get their high school education, get the GED, that they can get some technical training, and that they could get an opportunity for a job. And some day own their own home.

By the way, some of those services were being offered right there in this public housing unit. But, for some reason, those individuals weren't taking advantage of them.

I'm not sure that our discussion today really is going to end up dealing with that issue. What I'm suggesting is that somehow I have a feeling we need to rethink the whole thing as opposed to just getting in this debate about whether it's management of HUD or whether it ought to be disbanded.

Mr. **Van Dusen**. Senator, could I express my gratitude for your appreciation of the fact that my rather radical suggestion with respect to the Department was not made in a mean spirited way, but simply as a different way of meeting the needs that I expressed in our articulation of the mission of the Department.

Let me also commend your focus on the family because I think the problem which you've described in the Florida housing project is one which requires governmental focus in a broad range of our programs and activities on ways to strengthen the family unit, which has been disintegrating and eroding over the past 20 years.

And that really is critical to the accomplishment of any of the objectives that we're talking about.

Mr. **Weaver**. That gets me a little far afield. But, you know, recent research has shown that this organization of the family is largely an economic phenomenon. The men who are in the group that has this problem just aren't there. Some of them are incarcerated. Some of them are dead. And some of them are not capable of assuming the responsibilities of families.

So that means that you get back to the basic economic problem. And that is the problem of employment and jobs.

William Julius Wilson at the University of Chicago has written a book called "The Truly Disadvantaged," where this is pointed out. It is certainly not something that HUD could be doing. It's not something HUD should try to do. And I don't think there's anything so far that we're going to be able to do about it because people just don't look at that as a great problem.

To me, it is.

Mr. **Brownstein**. Let me say that I've known and have highly regarded Dick Van Dusen for a long time, and John Rhinelander as well. And I know how dedicated they are. They're not at all callous or uncaring in their attitude toward taking care of poor folks. And I will have to confess also that a lot of things that I was very certain about 40 years ago that would solve all these problems just ain't true. And I know much less or have much less certainty about what the answers are today than when I thought I knew what the answers were back at that time.

There are very difficult social problems here, Senator Mack, and I guess one of the difficult and frustrating problems we all have is how best to deal with them.

And my suggestion of making the HUD programs work is that here at least is an entity that can do some things. And rather than to throw it all out and start anew somewhere or go back to where we were before there was any governmental involvement—and that's another thing I think we ought to bear in mind.

The reason that these programs came into being was because of default on the part of the local communities and on the part of the States. Things weren't getting done. That's why virtually every Federal social program came into being.

So, when I hear suggestions that we ought to get things back to where they can really be done, the States or the community, I always reflect about:

Well, why are they here in the first place? Wasn't that because they weren't being done at that time?

Yes, there are some States and there are some communities that do an excellent job, but there are also a lot of them that don't do anything. So rather than discard the Department and start anew I would suggest taking what is there and making it effective.

Senator **Graham**. Thank you very much, gentlemen. This has been an extremely valuable and stimulating panel. And you have set the context in which we will be thinking about these issues over the next several months.

I appreciate your participation today and would like to reserve the opportunity of calling upon you again, individually or collectively, as our knowledge and appreciation of these issues grows.

Thank you.

If the second panel would please come forward.

We learned late yesterday of the death of the mother of one of our distinguished participants, Dr. Michael Stegman, and that he would naturally be unable to attend today's hearing.

On behalf of the subcommittee, I would like to extend to Mr. Stegman and his family our condolences.

If the two members of the second panel will please stand; as indicated earlier, it's the practice of the committee to swear all witnesses.

[Witnesses sworn.]

Senator GRAHAM. Thank you very much.

I will introduce briefly our two panelists, ask that they would each give their statement. Then, we will turn to questions.

Mr. Anthony Downs is a senior fellow in economics at the Brookings Institute.

Mr. Rudolph Penner is a senior fellow at The Urban Institute.

Mr. Downs.

STATEMENT OF ANTHONY DOWNS, SENIOR FELLOW IN ECONOMICS AT THE BROOKINGS INSTITUTE, WASHINGTON, DC

Mr. DOWNS. First of all, I appreciate the chance to testify here. I would point out here, however, that whatever I say is my own opinion, not necessarily that of the Brookings Institution or its trustees or its other staff members.

I have to say that. In fact, I've said it so often, I believe they don't have any opinions whatsoever. [Laughter.]

In my allotted instant of 5 minutes, I want to make five main points.

First, HUD has multiple constituencies and multiple missions, and these are spelled out more in my written statement.

Like most Federal agencies, its major missions can roughly be divided into two groups: Helping nonpoor households and business firms achieve their goals by helping finance homes and stimulating housing construction; and combating poverty by providing financial assistance to poor households, public housing authorities, and city governments.

The second point is that the nonpoor constituents of HUD have much more power than the poor ones, even though the poor ones are the ones who need help much more than the nonpoor ones. That influences the way HUD allocates its resources.

My third point is that HUD's performance of its antipoverty mission is hampered by a consistent unwillingness of any administration or any Congress to provide it with enough money to make its housing aids into entitlements. With the exception of home owner tax benefits, all HUD programs are for a limited number of the people who are eligible. None of them are for all the people who are eligible.

This is mainly because housing is a very expensive element in life, as Secretary Weaver and Phil Brownstein pointed out. They both emphasized that.

Furthermore, the more successful HUD is in aiding the poor, the more its success arouses resistance from the nonpoor majority in the country—for two reasons.

The first is that greater success means higher cost, and higher cost amounts to very large amounts of money.

Second, poor households receiving HUD aids start moving into nonpoor neighborhoods where the existing residents don't want them to live. Therefore, the more successful a HUD program is, the more resistance mounts to it until it's shut off, primarily because it is successful. As a result, HUD programs tend to have a cyclical character. They are created and started with great fanfare but turned off as soon as they become very strong or successful.

That happened in the early 1970's when the Nixon administration had a moratorium on housing subsidies after two of the greatest housing subsidy construction years in American history. It happened again under the Reagan administration after the Carter administration had several years of large scale housing subsidies.

HUD programs for the nonpoor are also cyclical because they're related to the general business cycle, though for somewhat different reasons.

My fourth point concerns HUD's recent scandals. They have two causes.

First of all, all Government programs involving major procurement spending create great temptation for corruption and political influence. As some of the previous speakers have said, such temptations are inescapable and can only be resisted by effective administration.

The Department of Defense is another example, which has also had scandals for the same reason. There is no way to eliminate this temptation altogether.

Second, when a department has zero priority in the eyes of the President and his leadership group, as HUD did in the 1980's, then the people who are appointed to run it are likely to have little concern with how well it serves its constituents. That's another point that was made by Mr. Brownstein.

Those people focused their efforts on careerism and personal power rather than upon effective service to the agency's constituents. This attitude will almost certainly combine with the temptation I mentioned to create scandals. Since the President and other leaders of the administration didn't give a damn whether HUD was alive or dead, they didn't care whether its programs were effective or not. So there was no oversight from beyond the Department itself to determine whether it was, in fact, serving its constituents well.

The cure for these scandals is not dismantling HUD or redesigning its programs or incumbering them with 10 more layers of redtape and reports. The cure involves two things.

The first is a different attitude toward the importance of HUD by the President himself and his top leadership than was evident in the Reagan administration.

The second is appointment to HUD of top-quality people who truly care about serving its constituents well.

This really repeats a point that all the previous speakers made: That the quality of the people appointed and their commitment to actually providing services that the Department is supposed to provide is what really will make any administration effective.

My fifth and last point is that HUD's effectiveness could be improved in the long run by requiring that a small percentage of all HUD program funds be used to evaluate program effectiveness through outside evaluators. Preferably, they should be from outside the Department altogether, but certainly from outside that part of the Department which is administering each program.

An example of such evaluation is the Manpower Demonstration Research Corp. in New York. It is a quasi-private agency founded by several Federal agencies to evaluate their own programs.

Another example is the Experimental Housing Allowance Program funded by HUD but run by outside contractors. It conducted an experimental program that lasted 10 years and provided more knowledge about housing markets than all previous research put together.

I see my light is about to go off, so I'll stop.

[The complete prepared statement of Anthony Downs follows:]

TESTIMONY OF ANTHONY DOWNS

Senior Fellow
The Brookings Institution

BEFORE THE HUD INVESTIGATIVE SUBCOMMITTEE OF THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS OF THE UNITED STATE SENATE

Room 534, Senate Dirksen Office Building
Washington D.C.
January 30, 1990

1. Introduction. I am happy to be able to testify before this Subcommittee about certain aspects of the operations of the U.S. Department of Housing and Urban Development (HUD). The views expressed in this testimony are solely my own, and not necessarily those of the Brookings Institution, its Trustees, or its other staff members.

2. HUD's Constituencies and Missions. One of HUD's basic problems is that it has several different constituencies with very different needs and problems. Each constituency thinks HUD has a main mission serving its own interests. Hence HUD in fact has multiple missions, like most other federal agencies. These major constituencies and the missions they want HUD to pursue are described below (HUD also serves many other smaller constituencies with other missions that I will not try to describe here):

   a. The real estate industry. This industry has several major parts too, such as homebuilders, realtors, savings and loans, banks, insurance companies, developers, etc. HUD's main mission from the viewpoint of this industry is stimulation of housing production -- both new building and rehabilitation.

b. Middle-income households who make use of financial instruments aided by FHA, GNMA, FNMA, or FHLMC. They are not directly subsidized in most cases, but benefit from lower interest rates that federal guarantees make possible for them. HUD's main mission from the viewpoint of this constituency is **making it easier for non-poor households to finance homeownership.**

c. City governments. Large cities are overburdened with poverty and other problems associated with poverty. Hence they seek financial aid from HUD to cope with their poverty-related problems. HUD's main mission from the viewpoint of this constituency is **providing financial assistance to city governments -- the less restricted in use, the better.**

d. Low-income households in need of housing assistance. Their greatest need comes from their poverty status. They need financial aid, not necessarily tied to housing, in order to cope with their poverty. This group includes residents of public housing. HUD's main mission from the viewpoint of this constituency is **providing financial assistance through housing aids that will help improve their disposable income.**

e. Minority groups within cities. Many members of this constituency are also quite poor and overlap with the previous group. From their perspective, the main mission of HUD is **improving housing and other opportunities for minority groups.**

f. Public housing authorities. These organizations were created by the federal government and local governments, and need continuing federal financial aid to survive and to maintain their housing adequately. From their perspective, HUD's main mission is **supporting and improving existing public housing.**

The last four of these missions are closely related to each other. All four are basically responses to the poverty of many urban households. Hence, in the rest of this testimony, I will refer to all four of these missions combined as HUD's mission of attacking urban poverty through housing assistance.

3. HUD's Allocation Problem. HUD has a key problem in determining how it should allocate its scarce resources among those missions serving different constituent groups. Congress generally earmarks what parts of the resources available should go to which groups, but HUD has some discretion both in spending Congressional appropriations and in requesting future appropriations.
    a. The HUD constituents truly most in need of federal financial assistance have the least political power and clout with HUD. These are the last four constituent groups listed above. Conversely, the real estate industry and middle-income households have the most political power with a Republican Administration. But members of these groups are not poor or in real need of federal funding assistance most of the time.
    b. It is true that multi-family housing starts have never been very high in the U.S. except during periods when the federal government was deliberately stimulating them through special financial assistance. That took the form of either tax benefits for investors, as in the 1981 tax act, or direct subsidies, as in the 1968 HUD legislation. So this industry cannot attain very high levels of new construction without direct federal stimulation.

4. A Fundamental Constraint on HUD's Anti-Poverty Mission Performance. The basic problems of four of HUD's six constituent groups (all but the real estate industry and middle-income users of HUD financial instruments) are really rooted in the poverty of millions of urban residents. Yet the federal government -- both Congress and the Administration -- has never been willing to use HUD as a major instrument for a concerted, full-scale attack on poverty. This has been true under both democratic and republican administrations. Instead, both branches of the federal government have only given HUD enough funds to make a partial assault on poverty through housing assistance programs. Those programs have never been large enough to constitute full entitlements (except for homeowner tax benefits).

   a. Normally, HUD programs aimed at attacking poverty consist of many different half-hearted attempts to aid a small proportion of eligible households. Hence they often rank more as symbolic gestures of concern than as programs designed to have major effects. Such symbolic gestures certainly benefit those people who receive their aid. But they are not designed to attack the problems at which they are aimed with real effectiveness. In fact, whenever they appear likely to become very effective, that often creates a new problem for HUD.

   b. Whenever HUD's housing-related programs have become large enough to make a really big difference, they began to upset other groups in the society. Those groups are not HUD's constituents, but have a great deal of political power. This occurs whenever HUD programs cause or facilitate the movement of low-income households, particularly blacks, into non-poverty neighborhoods. This disturbs residents of those neighborhoods, who clamor for cutbacks in the programs to end this force that they regard as destabilizing. This situation was clearly behind cessation of the largest-scale HUD subsidies ever, in the early 1970s under President Nixon (as a left-over from the 1968 Housing Act passed under President Johnson). It also had some influence in causing the Reagan Administration to reduce the extensive housing subsidy activities started under the Carter Administration.

c. As a result, most HUD programs aimed at combatting poverty have a stop-and-go quality and history. They are started whenever housing problems become highly visible and acute, especially when a general recession has caused a big drop in new housing production. Then new housing programs serve the dual mission of stimulating housing production and aiding the poor. But when such programs become geared up enough to make a real difference, they are cut back.

d. This keeps most of HUD's programs at relatively small scale, in relation to the problem universe to which they are addressed. It also causes a continuous innovation of new programs with each new Administration, since earlier programs have been dismantled or discredited as part of the effort of cutting them back.

5. The Resulting Frustration and Inconsistency of HUD's Anti-Poverty Mission. It is clear from the above analysis that, insofar as one of HUD's major missions is conceived of as an attack upon urban poverty (which is the way current HUD Secretary Jack Kemp has conceived of it), HUD cannot succeed in carrying out this mission very effectively. Neither the Administration nor the Congress really wants it to do so. This is evident from the fact that HUD is continually hampered by the lack of funds authorized or

appropriated for it in relation to the size of the problems involved. This creates a very frustrating situation for HUD those officials who really understand what is happening and who have a genuine desire to carry out this mission effectively.

It might be argued that all federal agencies are hampered from fully attaining their basic missions by lack of funds, since resources are scarce and desirable missions abound. But other federal agencies are given enough funds by Congress to make some of the most basic services they provide entitlements available to all eligible persons who want to receive them. Examples are food stamps, Medicare, and Aid to Families with Dependent Children. Yet this never occurs with HUD, both because housing is more costly to provide than any other basic benefit (except perhaps full medical care), and because housing apparently has lower priority in the eyes of Congress and the Administration than other necessities of life.

6. HUD's Non-Poverty-Oriented Missions and Programs. Another set of HUD programs associated with FHA, GNMA, etc., are aimed at a middle-income constituency. These programs can be operated at scales large enough to make them quite effective, since they have usually not required direct federal funding or subsidies. Tax benefits for homeowners are similar, although they actually resulted from accidental features of the tax code rather than a deliberate policy aimed at their creation. Hence these programs have less of a stop-and-go nature, though their volumes may vary cyclically with the business cycle.

7. The Causes of Recent HUD Scandals. Recent HUD scandals have been caused primarily by two factors that have very little to do with the basically frustrating situation described above.

   a. The Inherent Temptation of All Large-Scale Procurement. The first factor is that all federal agencies engaged in procurement of goods or services that involve large sums of money are exposed to forces seeking to illegally seize some of that money, if necessary by corrupting federal officials. This is by no means unique to HUD, but is also found in the Defense Department, the Government Services Administration, and the Department of Agriculture, to name just a few. Money attracts potential crooks, wherever it may be. That has always been true of HUD, and always will be. But it alone is not sufficient to explain why the recent scandals occurred.

   b. The Low Priority Awarded HUD by the Reagan Administration. The second factor is the extremely low priority awarded to HUD's missions, and even its very existence, by the Reagan Administration. The President and his staff did not give even a tiny damn about cities, housing, minority groups, low-income households, or public housing authorities -- four of HUD's six constituencies. They would just as soon have HUD disappear as put any resources into it. Hence they both slashed appropriation requests and assigned people to HUD who knew very little about it and had no real concern with the needs of its constituents.

      1) It is my suspicion -- though I have not studied the matter carefully -- that many of the top people assigned to run HUD were republican supporters who had no

particular knowledge or talents to run anything -- and certainly not housing or urban programs. Yet they were considered worthy of getting a federal job somewhere as a political reward for their campaign contributions or activities. Since HUD was an agency where effective performance was irrelevant to the Reagan Administration's goals, why not assign such people to HUD? And why worry about what kind of a job they were doing there -- in terms of serving HUD's constituents -- since such service did not interest the Administration? That approach put into HUD offices many political appointees who had no real concern with whether the agency served its constituents well.

c. The Result: Poor Performance. When an Administration combines the inescapable temptations -- both financial and political -- of large-scale procurement with the lack of concern about true results with which the Reagan Administration approached HUD, the likelihood that some people will succumb to those temptations is very high indeed -- probably .999. Such succumbing need not involve the outright stealing of money by HUD officials, though apparently some of that took place. Rather, it may consist of their allocating public money so as to maximize their own personal power or sense of importance, without much regard to how well that money serves the true needs of HUD's constituents. That is what I believe caused the scandals in HUD.

d. Possible Remedies. The remedy for these scandals does not consist in abolishing HUD, or limiting its programs to inexpensive ones, or assigning one or several more watchdog agencies to monitor its officials through ever-more-complex regulations and accounting procedures. Rather, the remedy has two parts.

1) First is a change in the attitude of the highest officials in the Administration, from the President on down, to a genuine desire to make HUD an effective agency in serving its constituents -- something that was never present under President Reagan.

2) Second is the appointment of top-level people to run HUD who have a genuine interest in serving HUD's constituents effectively, rather than simply a desire to maximize their own careerist interests or influence. At least some of those people should have extensive experience in the relevant fields. However, it is possible to get competent, excellent top-level officials to run HUD who have had little such experience, as the case of Secretary Carla Hills proves. She did a very creditable job in spite of her lack of prior experience in the fields concerned.

8. An Additional Way to Improve HUD's Performance. HUD has rarely carried out statistically valid evaluations of its own programs to determine (1) how effective they are at achieving their desired effects and (2) what other effects, both desirable and undesirable, they might be having. In fact, few government or private agencies thus evaluate their own behavior, for two good reasons. First, scientifically valid evaluations are hard to design, hard to carry out, and costly. Second, no one wants to conduct an evaluation that might reveal his or her behavior was not very effective. It would be politically foolish to design and pay for an evaluation that might undermine one's own

reputation and credibility. Hence few valid evaluations are ever carried out. Yet the federal government spends billions of dollars on programs which have complex effects with unknown relationships to their stated purposes.

If Congress wants to make HUD more effective, it should mandate that HUD spend a certain percentage of the money allocated to any program in conducting scientifically valid evaluations of how effective that program really is. Such evaluations should be carried out by outside contractors, not HUD officials themselves, since no one is a good evaluator of his or her own behavior. An example of how such evaluations could be carried out is provided by the Manpower Demonstration Research Corporation (MDRC). This is a private agency with an independent board of directors funded by several federal departments to test proposed programs scientifically in order to determine how effective they are. MDRC usually tests new programs before they are adopted at scale, rather than evaluating on-going programs already being carried out at scale. But its methods could be employed to do the latter as well. HUD should be required to set up such an agency, or to use existing ones to perform similar functions, for all of its major programs.

HUD conducted such an evaluation once before, concerning the housing voucher or housing allowance proposed by the Nixon Administration. Congress directed HUD to conduct a ten-year social experiment, called the Experimental Housing Allowance Program (EHAP). This was one of the largest social experiments ever carried out, involving 12 cities over many years. In two metropolitan areas, full-scale housing allowance (voucher) programs were established and carried out, with funding provided for all eligible households who chose to participate. Dozens of statistically-valid tests were set up and conducted to discover what impacts this program had upon actual housing conditions. I believe it is accurate to say that more valid information about how housing markets operate was gathered from this one experiment than from all previous empirical studies combined. A great deal was learned about how housing vouchers worked in practice that was not clear from theory alone. Similar evaluations of other HUD programs, both before and after their adoption, could be immensely valuable. They would also help detect programs that were not working well. The mere knowledge that every program would eventually be subjected to such an impartial, outside evaluation would constrain persons interested in profiting illegally or unjustly from doing so in any ultimately detectable way.

Senator **Graham**. Thank you very much, Mr. Downs. You have opened yourself to some interesting questions.

Mr. Penner.

STATEMENT OF RUDOLPH PENNER, SENIOR FELLOW, THE URBAN INSTITUTE, WASHINGTON, DC

Mr. **Penner**. Thank you, Mr. Chairman. I appreciate this opportunity to testify. I should note at the beginning that I am not knowledgeable about the details of the recent HUD scandals; because I was invited to testify fairly late, I have not had a chance to research the relevant issues.

I shall, therefore, confine myself to stating a few general principles regarding the role of oversight in attempting to curb corruption in Federal programs.

These observations are based on my experiences working at HUD, OMB, and CEO. Most important by far, it is crucial to recognize that some program designs invite corruption more than others. If a program is designed to invite corruption, it's very difficult to overcome the incentives for dishonesty by intensifying oversight efforts.

Consequently, it is more important to get a program designed right in the first place rather than to spend a great deal of time and resources designing oversight procedures.

The main thing to be said generically about the type of programs that are most vulnerable to corruption is two points that are fairly obvious.

First, any program involving the payment of large sums to a very few people invites potential contractors to try to gain political advantage through their contacts in the Congress and the executive branch.

Conversely, programs paying small amounts to large numbers of people, though not corruption-proof, are much safer.

For this reason, I strongly favor programs that try to improve low income group's welfare through vouchers and existing housing programs rather than through providing new housing with large development projects.

Second, any programs rewarding contractors with fees or commissions based on appraised values of property are particularly dangerous. I'm thinking of real estate commission fees, developer fees, and coinsurance fees that got that program into so much trouble. Such a reward structure creates a powerful incentive to overvalue properties, and it probably cannot be resisted.

This, in turn, is a recipe for default on government-insured mortgages. Ironically, when that happens, the loss to the taxpayers is often much greater than the amounts gained by unscrupulous contractors.

Again, this suggests that existing housing programs are much safer than construction programs.

Of course, regardless of how programs are designed, some oversight is required. It is my experience that the strongest protection against corruption can be found in the inspector general's offices of the various departments. One cannot expect OMB to provide much management oversight and, indeed, inserting the "M" in OMB has never worked very well. OMB can play an important role, however, in the analysis necessary to design programs that are less vulnerable to corruption.

I believe they need more resources to restore their previous analytic capabilities and to travel more, so they can actually observe programs in action.

The concern of the Congress over travel budgets has been the classic case of being penny-wise and pound-foolish. OMB has essentially no travel money and its personnel levels are only slightly greater than those of the late 1940's, when they had far fewer duties.

The Congress could help in various ways. I find it incomprehensible that the Congress resisted Secretary Kemp's request to do away with certain discretionary accounts that invited sordid activities.

While at HUD, I found myself wasting a great deal of time working on reports mandated by the Congress, and I never saw any evidence that anyone actually read them.

I yearned for more time to spend managing my programs. The Congress could scrub those requirements and give HUD employees more time to do useful work.

In conclusion, the Congress' main role should be in assessing the vulnerability to corruption when designing programs. One should always begin by assuming the worst possible set of scoundrels out there. More resources should be given to OMB but for analysis and not for the purposes of detailed management oversight.

Fundamentally, the strongest oversight must come from within departments. It is important to insure that the inspector general is independent and has sufficient resources to do his or her work. It's also important that the Congress refrain from requesting frivolous reports and excess testimony and imposing other duties on people who are supposed to be running programs.

Thank you.

[The prepared statement of Rudolph G. Penner follows:]

Statement of

Rudolph G. Penner

Senior Fellow
The Urban Institute

before the

Senate HUD Investigative Subcommittee

January 30, 1990

The views expressed are those of the author and do not necessarily reflect the views of the trustees, executives, or staff of The Urban Institute.

STATEMENT BEFORE SENATE HUD INVESTIGATIVE SUBCOMMITTEE

RUDOLPH G. PENNER

The Urban Institute

Thank you for this opportunity to testify.

I should note at the beginning that I am not knowledgeable about the details of the recent HUD scandals, and because I was invited to testify fairly late, I have not had a chance to research the relevant issues.

I shall, therefore, confine myself to stating a few general principles regarding the role of oversight in trying to curb corruption in Federal programs. These observations are based on my experiences working at HUD, OMB, and CBO.

1. Most important, by far, it is crucial to recognize that some program designs invite corruption more than others. If a program's design invites corruption, it is very difficult to overcome the incentives for dishonesty by intensifying oversight efforts. Consequently, it is more important to get the program design right in the first place rather than to spend a great deal of time and resources designing oversight procedures.

2. Can anything be said generically about the type of programs that are most vulnerable to corruption? Two points are fairly obvious. First, any program involving the payment of large sums to a very few people invites potential contractors to try to gain political advantage through their contacts in the Congress and Executive Branch. Conversely, programs paying small sums to large numbers of people, though not corruption proof, are much safer. For this reason, I strongly favor programs that try to improve low income groups'

welfare through vouchers and existing housing programs rather than through providing new housing with large development projects.

Second, any programs rewarding contractors with fees or commissions based on appraised values of properties are particularly dangerous. I am thinking of real estate commission fees, developer fees, and the coinsurance fees that got that program into so much trouble. Such a reward structure creates such a powerful incentive to overvalue properties that it probably cannot be resisted. This, in turn, is a recipe for default on government-insured mortgages. Ironically, when that happens, the loss to taxpayers is often much greater than the amounts gained by unscrupulous contractors. Again, this suggests that existing housing programs are much safer than construction programs.

3. Of course, regardless of how programs are designed, some oversight is required. It is my experience that the strongest protection against corruption can be found in the Inspector Generals' Offices of the various Departments. One cannot expect OMB to provide much management oversight and indeed, inserting the "M" in OMB has never worked very well. OMB can play an important role, however, in the analysis necessary to design programs that are less vulnerable to corruption. I believe they need more resources to restore their previous analytic capabilities and to travel more so that they can actually observe programs in action. The concern of the Congress over travel budgets has been the classic case of being penny wise and pound foolish. OMB has essentially no travel money and its personnel levels are only slightly greater than those of the late 1940s when they had far fewer duties.

4. The Congress could help in various ways. I found it incomprehensible that the Congress resisted Secretary Kemp's request to do away with certain discretionary accounts that invited sordid activities. While at HUD, I found

myself wasting a great deal of time working on reports mandated by the Congress and I never saw any evidence that anyone actually read them. I yearned for more time to spend managing my programs. The Congress could scrub all of those mandates and give HUD employees more time to do useful work.

In conclusion then, the Congresses' main role should be in assessing the vulnerability to corruption when designing programs. One should always begin by assuming the worst possible set of scoundrels out there. More resources should be given to OMB, but for analysis, and not for purposes of detailed management oversight. Fundamentally, the strongest oversight must come from within Departments. It is important to insure that the Inspector General is independent and has sufficient resources to do his or her work. It is also important that the Congress refrain from requesting frivolous reports, testimony, and imposing other dubious duties on people who are supposed to be running programs.

Senator GRAHAM. Thank you, Mr. Penner.

Both of you have suggested that there is a relationship between the level of interest of the managers or the highest levels of government in a particular program and the competence with which that program will be managed.

If the President is very interested in Defense, presumably, the Defense Department will get high levels of Presidential involvement, interest and high standards of personnel appointed to important positions.

Conversely, a department such as HUD, which had a low status, will get the inverse effect.

Within HUD, there were some programs that did have support at the highest levels, particularly those that related to middle income Americans—Fannie Mae, Ginnie Mae, et cetera.

Did you sense any difference in the way in which those programs were managed vis-a-vis moderate rehabilitation and section 8 and others that were targeted at low income people?

Mr. DOWNS. I can't answer that from direct experience, because during the Reagan administration, I had very little direct contact with the Department. But you mentioned Fannie Mae and Ginnie Mae, both of which operate very different kinds of programs from the ones that moderate rehabilitation is about. They're large-scale, more of the type that Rudy described. They involve a lot of small things being put together rather than a few big ones.

So they are of different character. I didn't mean to imply that the President's personal concern with a specific part of the Department would improve its quality. I meant that, if the President thought it was important that the Department perform its service well, he would appoint good people to it and those people would be the kind that had a dedication to doing that.

Then, if he had continuing interest in it over time, not in detail, I think that would support their morale and support the kind of people who were interested in providing good service to their constituents.

Mr. PENNER. I think there is a lot of truth to what you say. High-level interest does tend to discipline management to some degree. But it is also the case that, if the high-level interest by the President is successful in getting a very large increase in resources and programs are growing very rapidly, that's often a very dangerous time for a department, as we saw in the Defense Department in recent years.

Senator GRAHAM. I'd like to focus on the issue of oversight with particular attention to the responsibility of Congress. I see Congress as having several levels of obligation. One is to assure that within the executive branch, starting within the agency itself, there are the capacities, both structural and the resources to make the structure work, to accomplish effective oversight.

Could you comment first within HUD itself, the inspector general process, or other systems that have been inserted in the Department which have as their objective to give continuous monitoring of the effectiveness and the public spiritedness with which programs are being conducted?

Your comments as to how well that internal to HUD system is operating?

Mr. PENNER. I cannot comment on the experience of the last few years. I worked at HUD 15 years ago during the last HUD scandals, which bore many resemblances to the current HUD scandals.

In that day, the inspector general's office was enormously valuable in uncovering those scandals and pursuing the culprits. That's why I said favorable things about inspectors general.

I do think, as we have labored under tight budgets in the last few years, there has been some tendency to cut in the wrong places. I go back to my basic point that program design is very important.

As the former HUD officials pointed out, HUD programs are unusual in their complexity. They require a lot of hands on management from HUD. And much of the response to the budget stringency facing HUD has been cut in staff. And I think that was probably very unfortunate.

The kinds of programs HUD manages are very labor-intensive. I would like to see HUD reformed radically so that were not true, but it is, in fact, the case today.

Mr. DOWNS. There are two kinds of effectiveness to evaluate. One is honest administration of the program, and honest handling of money, which is what the inspector general is primarily concerned with. The other is determining whether the program, even if carried out honestly, is achieving the substantive objectives which Congress had in mind, and what other effects it has.

I've never been an official inside of HUD so I can't give you much comment on the inspector general. But I think there's a need for another kind of effectiveness evaluation, which is not really carried out by the inspector general.

It seeks to find out what impacts the programs are having on housing conditions in the markets where they're designed to operate? And are they achieving the substantive goals that Congress had in mind?

For that, I think a different kind of evaluation is necessary. HUD is now discussing with OMB and the Congress the mandatory use of program funds to do some of this kind of evaluation.

I understand there are a couple of arrangements being discussed within HUD. But I think it should be mandated by Congress that every HUD program should have a certain percentage of the funds appropriated for it spent on evaluating that program and its effectiveness in the broader sense that I've just described.

Senator GRAHAM. I'd like to come back to that point when we go to the second round of questions.

Senator Mack.

Senator MACK. Thank you, Senator Graham.

I want to build on that point as well because my instinctive reaction is to agree with you. I heard Rudy say that one of the problems he's observed is filling out reports which don't seem to be viewed by people and, therefore, the changes that might be suggested really never come about.

Do you have any difference?

Mr. PENNER. None whatsoever. I suppose, first, I should, because of the nature of this hearing, reveal potential conflicts of interest here. Tony was nice enough to mention MDRC as a potential performer of evaluations. I am on the board of directors of MDRC.

Mr. DOWNS. I didn't know that.

Senator GRAHAM. That's why the program works so well. [Laughter.]

Mr. PENNER. I had in mind quite different reports. There are certain periodic reports required by the Congress that have very little to do with HUD programs. One that was particularly burdensome when I was there—I don't know if it still exists—was the biannual report on urban development problems around America.

I strongly agree with the notion that program evaluation is very valuable. I note that the office I was concerned with at PD&R had a budget of $60 million when I was there. I think it now has about $15 or $20 million perhaps.

Mr. DOWNS. Half of which goes to one housing survey.

Mr. PENNER. That is correct.

I must say that I started it being assured that it would never cost more than $4 million a year.

Senator MACK. And it costs more than that, you say?

Mr. DOWNS. It costs about half of the research budget.

Mr. PENNER. I strongly agree with the merits of program evaluation. Tony mentioned the notion of doing it outside of government. I always thought that in the good old days that OMB did a good job of program evaluation outside of the Department, Senator.

They simply don't have the resources to do much of that any more.

Senator MACK. Mr. Downs, let me go back to a couple of your comments. Two causes that you mentioned, one, basically that large amounts of money just naturally draw people to get their cut and the zero priority from the leadership.

Would you feel that, at this point, with Secretary Kemp at HUD, that there is a different priority with respect to housing?

Mr. DOWNS. First of all, I don't know Secretary Kemp. I met him once when he and I both appeared on a television program and I found him very charming and a dynamic person. His statements certainly indicate a commitment to the constituency of the poor that I described, which I think is a big change from the previous administration.

And so that's a very positive factor. And many of the people that he has appointed those that I know are of high quality, and that's a very positive factor.

However, the real commitment will be expressed in how much money they are willing to spend. And so far such spending has not yet been forthcoming in any large magnitude in comparison with the size of the problem.

So I think the situation is better than it was in the previous administration, no doubt. But, how much better remains to be seen.

Senator MACK. Let me just build on that from the standpoint of some comments that were made by the first panel. Kind of, Mr. Downs, some of the reasons for the problem that we dealt with last year—political preference, privatization, cut-back in personnel, turnover, eight assistant secretaries for housing.

What really came to me as a result of that panel is, in essence, those people were saying:

Don't try to really redesign and redevelop and totally reform HUD, that the problems really developed from a hands-off attitude, a lack of management commitment in quality of people.

Would you both draw that same conclusion, or are there some specifics that you think we ought to be suggesting that would be helpful to see that those kinds of situations don't occur again?

Mr. DOWNS. Rudy already suggested some specifics, but that is my general comment.

Mr. PENNER. If I understand your comment correctly, I disagree with it rather strongly. Having lived through the earlier HUD scandals, I note many conceptual similarities between those and the more recent variety. Yet, the management team was quite different.

Indeed, I would say the group of people I worked with at HUD are some of the most able and dedicated people I've ever worked with anywhere.

That was not the problem. I go back to my fundamental point. I think the problem lies to a considerable degree in the complexity of the programs and the incentives for corruption generated within those programs.

Senator MACK. I think one of the comments that you made is that you would rather see the emphasis be placed on voucher programs, which is small amounts of money going to lots of people as opposed to large amounts of money going to a few people.

Is that fair?

Mr. PENNER. That's right. I'm not saying there isn't theft and some fraud in those programs, but I think it's very minor compared to what we see in the others.

Senator MACK. Do you say that really from trying to deal with the issue of corruption only, or do you believe that the program itself is a good solution to our housing problems?

Mr. PENNER. I think it is basically a very good program, but not necessarily as a solution to the housing problem. If I could step back a few steps.

I've always been of the old-fashioned view that the best thing that you can do for poor people is to give them money. Most of our social programs are moving in that direction, and food stamps have become essentially a cash program. Housing vouchers are really more an income-supplementing program as opposed to a housing program, per se.

They typically deal with people that already have a home. I think the homeless generate all sorts of other problems besides housing, but the voucher essentially is a way of helping a person fund the expenses that they already face and, generally, simply release money from what they spend on housing to support other kinds of expenditures that they might want.

It does have a housing component. We found in studying those programs that a particularly valuable aspect of them were the housing standards that go with them to make units eligible for subsidy.

Often, you could get a considerable improvement in a person's living condition with fairly minor expenditures of funds, things like fixing broken windows, fixing holes in screens, repairing holes in the wall, and so on. Often, the landlord was willing to do such things without any increase in rent. The program was valuable in drawing their attention to those kinds of deficiencies.

The increase in housing quality was obviously very small, but you spread it around more people. I think that's another advantage of a housing voucher program.

A very important point that Tony made is that these aren't entitlement programs. I call them rationed subsidies. New construction programs, because they are so expensive per unit, serve just a tiny portion of the eligible population. It's not fair to give a few people a huge jump in the quality of their housing while you're ignoring all sorts of other people.

What you do with vouchers is give a much larger number of people a small, admittedly very small, improvement in their housing conditions, but a more significant increase in their incomes.

Mr. **Downs**. May I say that I agree with Rudy that the housing voucher program is a good one. I think the previous witnesses made some statements about it that are somewhat misleading.

A housing voucher program is aimed at the most widespread housing problem in the country. It is not that people live in poor quality housing or that they are homeless. Rather, they live in housing which is of good quality but they have to pay such a high price for it that they must devote a very high fraction of their incomes for housing.

Over 20 million households have that problem. That's far larger than all other problems of homelessness, poor quality housing, and overcrowding put together.

Housing vouchers are aimed at that group of people. They do not have to be operative in an area where there's a loose housing market to be effective.

In an area where there's a tight housing market, everybody who lives in a quality unit but is paying a very high fraction of his or her income for housing, in that market, could be aided by a housing voucher.

So housing vouchers could improve the housing situation of a great many low-income households, even in a tight market. True, vouchers do not help those who don't have any homes because in a tight market, they can't find them.

But, vouchers do help in a tight market those who already have homes and are paying a high fraction of their incomes for housing. That group includes most of the low-income households in every metropolitan area.

So housing vouchers do work, even in a community with a tight housing market.

Mr. **Penner**. One of my major jobs at HUD was running a housing allowance experiment that, in a sense, was a precursor to the voucher program. Our data suggested that the majority of recipients didn't even move; they stayed right where they were. That was exactly as Tony said. The voucher provided a way of reducing the burden of the rent they pay where they were in the first place.

Senator **Graham**. I'm going to pursue Senator Mack's questions and then come back to where we were when we started.

If what you say is that the effect of the voucher program for many of its beneficiaries is not to change their housing circumstance, but rather to improve their discretionary income, is that an accurate statement?

Mr. **Penner**. That's correct, yes.

Senator **Graham**. Why is a housing voucher as opposed to some other alternative such as an income tax generated credit the most appropriate way to increase a person's discretionary income?

Mr. **Downs**. Well, it isn't. The difference between a housing voucher program and a straight income maintenance program is that the person receiving a housing voucher must live in a standard-quality housing unit. A person receiving straight income maintenance, has no housing quality requirement.

As part of the housing allowance experiment, we tested both those kinds of arrangements. We gave some people a housing allowance who weren't required to live in a standard quality housing unit—in other words, they just got money. We gave other people a housing allowance only when they occupied a standard quality housing unit.

The big difference was in the percentage of people eligible who took up the program,. When they were not required to live in a standard quality housing unit, about 80 percent of those who were eligible for aid actually accepted the assistance. When they were required to live in a housing unit of standard quality, only about 50 percent actually accepted the assistance.

Thus, being required to live in a standard-quality housing unit did force them to find one if they weren't in one already—and that took effort. That limited the number of people who were willing to accept it.

A straight income maintenance program would probably be more effective in attacking poverty. But Congress will not vote for a straight income maintenance program that funds everybody who is eligible—which makes it an entitlement program.

Congress is more likely to vote for a program which is tied to a specific supply of food, medical care or housing. Why? Because there is an industry attached to that kind of activity, that supports that kind of a program.

Senator **Mack**. Isn't one of the arguments that is used though against the straight income subsidy that they won't use it wisely? That they should be making better decisions about how much money they are going to spend on housing, and that type of thing?

Mr. **Penner**. That is an argument you often hear. Again, reflecting on our studies way back when, we found that, when the poor were given extra money, they spent it pretty much like middle class people would spend it. That doesn't mean they necessarily spend it wisely because middle class people don't necessarily spend it wisely.

Senator **Mack**. So the spending patterns were basically the same?

Mr. **Penner**. Very, very similar.

Mr. **Downs**. The most telling argument against straight income maintenance is that it reduces the labor supply, because some people will accept income maintenance and work less than before. Particularly in a household that has more than one person working, the second worker might work less if an income maintenance program is available.

There have been experimental programs done on income maintenance programs. They show that there is an overall drop in labor effort of between 6 and 10 percent when people receive straight income maintenance.

So that's the big drawback of such programs. In countries like Sweden that have such programs, that's one of their drawbacks.

Senator **Graham**. The previous panel, staying on the issue of vouchers, had talked about the need for a balanced program of supply and demand and that vouchers increased the demand capability of potential users of housing but did not necessarily result in an adequate supply.

One of the speakers commented that over the next 10 years, a substantial amount of our housing stock is going to move into a status of obsolescence.

I was recently in the city of Tampa and was told that they estimate that 1 percent of their housing stock every year goes into what they consider to be inadequate, less than acceptable for human habitation.

How do you respond to the need to maintain a supply of housing for low-income people within the context of your predominant recommendation that focuses on vouchers?

Mr. **Downs**. I think there is such a need. I believe that Phil Brownstein said 40 percent of the existing supply would disappear by the year 2000. I believe he was referring to the fact that there are many housing subsidy programs that will expire between now and the year 2000. If those subsidies are not renewed or those units are not prevented from being removed from the subsidy program, they will pass out of being available to low and moderate income households.

That is what he was referring to, I believe.

I think there are some housing markets where there is a serious shortage of low-rent housing. That shortage is getting worse in our country. And if you had a large amount of money to devote to housing programs, I think I would put some into creating more supply, although I would put more into housing vouchers.

The biggest problem and the one the biggest number of people are suffering from is lack of income, not lack of housing. Housing vouchers address that lack of income directly. There are over 20 million households suffering from that problem and the number suffering from other housing problems is very much smaller. Even the number of homeless, which is certainly the most acute housing problem, is less than a million, in my opinion. Maybe it is less than 750,000. Although that's a lot of people, it is a lot less than 20 million.

On the other hand, the homeless have the worst problem. I do believe that there is a role for supply-side programs, but it isn't as important as supplementing renter incomes. And if you have a very small amount of money, it's probably better to devote that money primarily to vouchers, because you can't do everything if you only have a small amount of money.

Mr. **Penner**. I agree with that very strongly. Money as embodied in vouchers relieves the symptoms of poverty. When you look at the fundamental causes of poverty, that involves more complicated issues, involving human capital and, frankly, in a period of limited resources, I personally would give a lot more priority to training programs and work experience programs and so on, trying to develop human capital rather than capital in housing.

Senator **Graham**. I'd like to return to the issue of oversight and talk some about the issue of oversight within the Department.

Mr. Penner, you talked about the fact that the M has not worked very well in OMB. Before coming to this job, I was Governor of a State and we assumed that it was our responsibility from the statehouse to have a mechanism with which we could monitor the program effectiveness and the ethical and value aspects of our line agencies. And we had to do that. An entity which was very similar to what I thought OMB was.

You seem to indicate that it hasn't worked very well, and seemed to raise some questions as to whether it has the capacity or potential to work much better.

If that's not the place to do it, where is the entity within the executive branch, outside of the line agency itself, that should be providing oversight?

Mr. **Penner**. Let me first say that the reasons that it hasn't worked very well in OMB may be the result of the history of that organization. That organization has always been an elite organization. It contains some of the best talent in Government. It has been an organization very strongly devoted to budgeting, as the Bureau of the Budget, and its budget functions just generally seem to dominate the attention of its leadership.

That has become more and more true as our budget processes become more and more complicated and more of a year-around activity rather than a seasonal activity, which it once was, believe it or not.

But, I really strongly believe that management initiatives have to come from within the department's themselves. I think it's very hard to impose management routines from the outside. And I've never been much of a fan of these artificial routines, like management by objectives, and so on.

I think it really is the case, as Tony said, and as all the previous panelists said, that it is a question of getting good people and keeping them for a substantial amount of time. And as a previous public servant who left, the pay was very relevant to me personally, I do think that presuming the pay increases go through that have been promised, that will help a great deal.

I also am in accord with an earlier witness who said that some of the financial disclosure requirements have gotten out of hand. I think we are in danger in trying too hard to prevent conflicts of interest after people leave Government.

We are in danger of making those requirements so oppressive that people may not be able to work in areas that they're good at.

So I do think that we have to look at all of the many obligations we place on public servants and on their rewards. I don't think that someone working for the Government should get quite as much as he would get in the private sector. But, the gap has widened to an extraordinary extent in recent years.

Senator **Graham**. Turn to a third level of oversight and that is the responsibility of the Congress. It would be generous to say that

Congress was asleep over the last 10 years as circumstances have developed in this Department, in the S&L industry and elsewhere.

What could be done to awaken the Congress and put it in its awakened state to a more constructive oversight of these agencies and programs which the Congress created?

Mr. **Downs**. That's a very broad question. I am not an expert on the organization of Congress. But one thing that could be done is to abolish half the committees and subcommittees that are now in existence and fire half the staff, to get down to a much smaller organization. It wouldn't have so much energy to spend thinking up more things for Federal agencies to do.

By saying this, I'm going to put myself in the same unpopular position as Mr. Van Dusen did when he suggested that HUD be abolished—which I don't agree with, by the way.

But I believe that Congress has not adequately reorganized itself and looked at its own functioning in relation to the tremendous size of the Federal Government. Congress has only reluctantly applied to itself the same standards that it's imposed upon all kinds of other agencies.

So it seems to me that getting your own house in order in general would be desirable. Again, I'm not an expert on how to do that. But you asked me for my views, so I'm telling you.

Mr. **Penner**. I would strongly agree with that.

One of the great problems in working with the executive branch is that you're potentially beholden to so many different subcommittees, select committees and full committees, just the testifying burden takes up a significant amount of a secretary's time.

The burden is just enormous and very frequently involves giving similar testimonies to numerous, numerous committees in the House and Senate.

I would add, however, that with a more limited testimony burden, more of that time should be devoted to program evaluation. I do think that, if you have good program evaluation, those analyses will show up not only fundamental flaws in programs as they attempt to compute the benefit/cost ratio, but will also reveal their susceptibility to corruption. They will sometimes uncover corruption that's actually occurring and that has not yet been discovered by other people.

Senator **Graham**. From your experience, do you have any models of what you consider to be the best practices in oversight within the Department, within the executive branch of the line agencies? Or between a parliament and an executive?

Mr. **Downs**. I have not been in the Federal Government, so I really cannot give you in my experience any outstanding examples. I'm sorry.

Mr. **Penner**. I have generally been, when involved in the executive branch, I've been involved in program evaluation mostly, so I suppose this is a self-serving remark.

But, within departments, I do believe that policy shops which have different names in different agencies, have an extraordinarily important function that should be given attention in budgeting and secretaries should be encouraged to use them a great deal.

Most do. But, every now and again, there are secretaries who allow it to fall into disuse.

Mr. **Downs**. You pointed out that the budget for PD&R, or what was PD&R under Secretary Weaver in 1968, was $60 million.

Mr. **Penner**. That was under Secretary Lynn back then.

Mr. **Downs**. But, as you say, it was very high. Today, it's less than $20 million. And in terms of constant value dollars, it is far less than that. There's been a cut of at least five-sixths and probably more in the PD&R budget. That shows right there the priority that past HUD Secretaries and the administrations put on research and evaluation.

Senator **Graham**. I was very interested, Mr. Downs, in your emphasis on effective evaluation as a key to dealing with the problems that we have just seen. I'm frankly surprised and I'm learning from the testimony at what a low priority we have placed on program evaluation.

In some other areas, I was particularly involved with the 1988 drug bill. We emphasized that a component of the expenditure for treatment programs and for education programs and enforcement had to go to an evaluation of those.

So that when we revisit those, we'll have some greater basis of empirical information upon which to make future decisions.

I wondered if you would like to supplement your comments in the written paper as to what you think the Congress ought to do relative to establishing a greater commitment to that type of evaluation within HUD.

Mr. **Downs**. Again, I have not devoted a great deal of thought to this previously. But in the past, mandating a certain percentage—maybe a half a percent or even 1 percent—of the funds appropriated for any program to evaluation of that program is one way to approach it.

I believe OMB has suggested to HUD that a certain amount of money, an absolute dollar value amount, be used by PD&R to evaluate all programs. In contrast HUD is suggesting that a percentage of program appropriations be used for evaluation, as I suggested.

But even if Congress mandated that, I'm not sure what the percentage should be. Maybe on very big programs, it should be a lower percentage on smaller programs because of the dollar amounts involved. But, that would be one way to ensure that evaluations were done.

Mr. **Penner**. I guess I would be very careful about mandating a certain percentage. That can turn out to be quite inappropriate in some circumstances. I think it's more a matter of looking at the budget allocation and just seeing what priority is given to policy analysis.

I mentioned that I was on the board of the MDRC. It's interesting to me that this is one of the few big organizations doing evaluations.

Most of the money comes not from the Government but from foundations. So again, it's just a symptom that not much priority has been given to evaluations.

Mr. **Downs**. But the MDRC was founded by the Labor Department and by HEW, in order to evaluate their proposed programs, I believe.

Mr. **Penner**. I'm not sure of that, Tony. The Ford Foundation played a big role in its establishment.

Senator **Graham**. Going back to how Congress has utilized its activities, maybe the first thing we ought to consider is whether to dismantle this subcommittee after our first hearing. [Laughter.]

So that would contribute to a smaller, leaner, more effective Congress. But, the nature of the kind of inquiries that Congress makes could affect the attitude as to the relative importance of executive agencies if Congress started to ask more performance-oriented questions. After a few stuttering responses, probably the person who is being interrogated would figure out that some performance-oriented information upon which to answer was important.

Mr. **Downs**. Another thing the Congress has is the GAO, which already conducts some evaluations. I once wrote a book on bureaucracy called "Inside Bureaucracy." I pointed out that the head of every large organization, including every Federal department, knows that somewhere underneath him, someone is screwing up badly. But he doesn't know who or where that is, because the organization is too large.

So he's always fearful of evaluations and investigations. That's why the GAO has an important function, because it is outside the agency.

The main reason why we don't have many evaluations in Government is that nobody likes to be evaluated. I don't think Congress is any more anxious to be evaluated than anybody else. No one likes to be evaluated and, therefore, one shouldn't ask the people who are running the programs to evaluate themselves.

But you ought to have somebody do it. You have to put outside pressure on any agency to get it to evaluate itself or any one part of itself. That pressure really has to come from outside the agency. That's why, although you might want to leave the performance of evaluations to someone in the department, the necessity of doing them has to come from outside pressure, the kind you suggested, or else from Congress mandating it.

Senator **Graham**. What's your impression of the data management systems, the management information which is available for HUD programs? Have you had an opportunity to look at it? Do you think it's adequate? Appropriately focused?

Mr. **Downs**. I have had no contact with that whatsoever, sir. I really can't answer that.

Senator **Graham**. Mr. Penner.

Mr. **Penner**. When I worked there 15 years ago, it was a disaster. Records were lost on many properties. I do not know what the situation is today, although some of the scandals did suggest deplorable accounting techniques, failing to identify pure theft in some cases.

Again, I think that Secretary Kemp's idea of having a financial comptroller, someone responsible for improving the financial recordkeeping system, is a very good one. I hope that it will be successful.

Senator **Graham**. A management system depends upon the kinds of questions that you expected to assist in answering. Going back to moderate rehabilitation, one of the early indicators that something was going on there was the fact that previously, when the program had been decentralized, the typical developer applicant, recipient funds was for a small number of units. The whole program was intended to be for moderate rehabilitation.

Once it became a centralized program, the number of units per applicant recipient mushroomed. You were dealing with fewer people, getting more money. And that, in my opinion, should have raised some questions in people's minds as to what was happening to these programs. And it could have started an inquiry that could have determined why it was happening and maybe sutured some of the abuses.

Are there any ideas about how, within the executive or within Congress, we can set up a red flag system to try to identify some of those indicators of a systemic malady in the system?

What is our thermometer that we can stick in the programs in order to get a general reading of their state of health?

Mr. PENNER. Well, I don't think there really is any easy system that Congress can use mechanically. I go back to the point I've emphasized several times, and that is that it is a matter of program design.

So, first of all, when the Congress constructs a program, it should be very sensitive to the kinds of incentives that are being created within it.

You should look for the red flags there. As you have suggested, once a program is created, the Congress tends to lose interest in it. They seldom go back and look at what has happened. They spend their time inventing new programs. There is really a need to look back at programs.

I think sunset laws are of some value in that regard. Not much, I'm afraid, because sometimes things are just recreated almost automatically. But a sunset mindset, if it was really applied enthusiastically, could be very valuable. If you could discipline yourself to require an evaluation periodically of the programs you've created in the past, it would be very valuable.

Senator GRAHAM. I agree with that.

I think when we got some of this from the first panel, there was a tendency to feel that if you're asking tough questions about a program, you must be its enemy. It's possible that friends of programs can also be concerned about their good health. And the friend of the program may more fundamentally be a friend of the objective of the program; if the specific program in place today is not the most effective vehicle to achieve that ultimate end, that your commitment to the ultimate objective should be primary.

And if that means dismantling your current vehicle to create a better one, do not feel intimidated to do so.

Mr. DOWNS. There is a tendency in HUD and in other Federal agencies, especially when there's a change of administration, to reject all previous knowledge because it wasn't invented in the new administration.

Before the Reagan administration came in, for many years, I was a consultant to many of the Secretaries of HUD. Time and time again, I suggested when they came in that they should evaluate the past administration's programs to see how they were working. But they didn't want to do that because they hadn't invented those programs. They wanted to create new programs for which they could get the credit, even if they did exactly the same thing under a different name.

So they refused to go back in most cases to evaluate what had been done in the past because they just didn't want to know.

That's a real problem, when there are political changes of administration. If it's not invented here, we don't want to know about it.

That behavior reduces the institutional memory of the organization drastically. Congress can play a role in maintaining institutional memories because there's more continuity in Congress in many cases than there is in the administration, especially with the high turnover of assistant secretaries.

Senator **GRAHAM**. I appreciate that endorsement for the Congress. [Laughter.]

Mr. **PENNER**. When things go wrong in the program, there's another unfortunate tendency. Both the press and the Congress finds it more interesting and more spectacular to look at cases of fraudulent behavior, people really being sinful and so on. The S&L crisis is a perfect example of that.

Much of the attention has been focused on outright fraud and misbehavior and bad management of some of the thrifts. But, the fundamental problem in the S&L crisis and the thing that's costing us most money is that most of those thrifts were very well-managed. It was them taking advantage of a set of bad incentives created by the system that got us into all of the trouble.

That's why I go back again and again to look at the basic incentives that the programs create.

Senator **GRAHAM**. I would editorialize that the only surprising thing about the S&L scandal is that it was contained to the level it was. The incentives were out there for anybody to see. And if you were so inclined, to take advantage of.

I appreciate the fact that we have extended your time beyond what we originally had indicated. If I could just ask in three areas that are going to be the subjects of some of our future hearings if you have any comments to make.

One that came up in the first panel is the issue of the layering of subsidies, where what appeared to be excessive financial benefits beyond what was necessary to get the private developer to act were involved.

Do you have any comments as to what steps Congress can take to try to give some greater insurance against oversubsidization?

Mr. **DOWNS**. Well, right now, the problem of layering in subsidies is much more acute in another sense. The subsidies available from the Federal Government are so de minimis, that most of the action done by so-called private/public partnerships in State governments and nonprofits requires the combining of multiple subsidies from different sources.

For example, if you're in some city in Massachusetts, in order to create any subsidized housing, with rents low enough for low-income households, you have to use State housing programs, Federal housing programs, charitable institution contributions, tax benefits and other different sources of subsidy simultaneously. No one of them is adequate to get the rents down to the level where poor people can afford them.

This is a different kind of layering from what you are suggesting. But nearly all subsidized housing being created today is financed on an extremely multiple-layered basis for this reason. It is only through this very, very complicated and cumbersome method of creating projects that rents can be brought down low.

If the Federal Government were to fund the kind of programs it has in the past, where its subsidy was large enough to get the rents down to where poor people could afford it, then this multiple layering would not be necessary.

I know that's not answering the question you asked, but my experience in testimony is:

If you have the opportunity to say something you want to say, you take it.

Senator GRAHAM. I think that's a very constructive observation.

Mr. PENNER. I probably am getting in over my head because of my ignorance of the gory details of the scandals, but my impression is that it isn't a problem of layering of the different subsidies and payments so much as it is the formula underlying each individual payment.

As I said in my testimony, you get a particular dangerous situation when the method of compensation is related to the size of the project.

In real estate commissions, for example, it's not very clear to me why the payment is a proportion of the property value. It seems to me about as hard to sell a $300,000 house as a $100,000 house. But that's how the industry is arranged. It creates some very bad incentives and was the fundamental reason that the 235 program got into so much trouble during my day.

Development fees as well tend to be based on the value of the project, again creating a strong incentive for fraudulent evaluations.

Perhaps with some thought, there might be better ways to structure the bidding process on projects so that the fees did not have the feature that they almost begged for misstatements of value.

Senator GRAHAM. That observation goes to the next question, and that is the issue of the way in which fair market rents are calculated. In our previous hearings, we have heard of a number of instances in which inflated fair market rents resulted in higher fees to people who arranged for the mortgage financing created a windfall of cash flow to the developer.

There has been considerable controversy within HUD as to how one goes about setting fair market rents.

Have either of you had any experience with that, or any comments on that specific issue?

Mr. DOWNS. I don't.

Mr. PENNER. I was there when you had to begin to decide how to do that. It's a very difficult problem, even conceptually, because each housing unit is such a unique thing in a particular location in a particular city with particular attributes.

So, even if done in the most honest fashion possible, it's very difficult conceptually to get it right. And I think as long as you try to run the programs the way they're now structured, you're going to have a problem with that.

In some cases, you're going to set those rents too low and you're not going to get people to participate. In other cases, they're going to be too high. It's almost inevitable.

Senator Graham. The last question that I have relates to the public/private partnerships into the decade of the 1990's based on the experience that we have had, particularly in the late seventies and eighties with public/private efforts to develop adequate housing and make it available to low-income persons.

Do you have any comments as to what the Congress should be sensitive to in shaping these partnerships in the future?

Mr. Downs. Up to now, the big problem of public/private partnerships has been the difficulty of funding the units, as I just described a moment ago. Therefore, all the public/private partnerships together that are now funded with or without Federal subsidies have been producing in the neighborhood of about 10-11,000 units per year. That is the best estimate I've been able to find.

This does not account for those that are funded by State housing agencies. It includes public/private partnerships with local governments, charitable organizations, nonprofits, et cetera.

That compares with the creation of 400,000 subsidized units a year in the early seventies when Federal subsidies were at their maximum.

The problem with public/private partnerships up to now has been the very low scale at which they've been able to operate, partly because it's so complicated to put these multisubsidy deals together. They work for months to make five units.

If Congress really wants to deal with the Nation's housing problems at scale, and wants to produce new units as part of a balanced strategy, it seems to me Congress is going to have to create very large-scale subsidy programs. They may be applicable to nonprofit organizations, public/private partnerships, and profit-making firms. But they will have to have Federal funding on a large scale.

Leaving housing problems to State and local governments and private agencies is simply not going to produce the scale of construction necessary to deal with these problems.

Senator Graham. Any comments, Mr. Penner?

Mr. Penner. I don't really have any comments on it. I don't know a lot about it except for the observation that it always seemed to me that our programs worked best at HUD when we had really intense involvement from the local community. That certainly complicates life but generally produced more effective programs.

Senator Graham. Mr. Downs, Mr. Penner, I appreciate very much your participation today, and I appreciate your indulgence in staying longer than we had originally indicated. But you have made a very significant contribution to our understanding and I hope the precision of our questions for future hearings.

Thank you.

[Whereupon, at 12:40 p.m., the hearing was adjourned.]

THE ANATOMY OF A DEAL

TUESDAY, FEBRUARY 27, 1990

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
HUD/Mod Rehab Investigation Subcommittee,
Washington, DC.

The subcommittee met at 10 a.m. in room 628, Dirksen Senate Office Building, Senator Bob Graham (chairman of the subcommittee) presiding.

Present: Senators Graham, Bryan, and Mack.

OPENING STATEMENT OF SENATOR GRAHAM

Senator Graham. I call the meeting to order.

Today we resume our investigation into the abuses and mismanagement of the Department of Housing and Urban Development.

This is the second hearing held by the newly created Subcommittee on HUD/Moderate Rehabilitation Investigations. The subcommittee will be focusing on the statutory, regulatory and management practices which need to change in order to put the agency back on its feet.

How much subsidy is enough to entice private developers to participate in the creation of low income housing? The purpose of this hearing entitled "Anatomy of a Deal" is two-fold. First, this hearing is intended to serve as an educational forum by providing a framework for understanding how HUD-assisted projects work. Second, it will explore the questions of what is the appropriate role of the private sector and what subsidy levels are necessary to make a deal attractive. We will explore these questions by examining two case studies.

First, we will look at a historic rehabilitation project involving the adaptive reuse of a former brewery into a 140-unit mixed-income apartment complex. This project, called "The Brewery," is located in St. Louis, MO and was developed by McCormack Baron & Associates. The second case study, Sierra Pointe, is located in Las Vegas, NV. The project involved rehabilitation of an existing 160-unit apartment complex. The entire project consists of low-income units. The developer of the project was Philip Abrams Ventures, Inc.

Both projects received several public subsidies, including moderate rehabilitation contracts, coinsurance, and tax credits.

We will conclude our hearing with a policy discussion by a panel of individuals who are well respected in the development community and who have demonstrated a commitment to producing low-income housing. We will focus on the role of the private sector, appropriate subsidy levels, relationship between risk and return, and reforming the way HUD does business.

My colleague and the ranking minority member of the subcommittee, Senator Mack, do you have any opening comments?

[The complete prepared statement of Senator Graham follows:]

PREPARED STATEMENT OF SENATOR GRAHAM

Good Morning. Today we will resume our investigation into the abuses and mismanagement at the Department of Housing and Urban Development. This is the second hearing held by the newly created HUD/Mod Rehab Investigation Subcommittee. The Subcommittee will be focusing on the statutory, regulatory, and managment practices which need to change in order to put the agency back on its feet.

How much subsidy is enough to entice private developers to participate in the creation of low income housing? The purpose of this hearing, entitled "Anatomy of a Deal", is twofold. First, this hearing is intended to serve as an educational forum by providing a framework for understanding how HUD-assisted projects work. Second, to explore the questions of what is the appropriate role of the private sector and what subsidy levels are necessary to make a deal attractive.

We will explore these questions by examining two case studies. First, we will look at a historic rehabilitation project involving the adaptive reuse of a former brewery into a 140-unit mixed income apartment complex. This project, called The Brewery, is located in St. Louis, Missouri and was developed by McCormack Baron & Associates. The second case study, Sierra Pointe, is located in Las Vegas, Nevada. The project involved rehabilitation of an existing 160-unit apartment complex. The entire project consists of low income units. The developer for the project was Philip Abrams Ventures, Incorporated. Both projects received several public subsidies including Moderate Rehabilitation contracts, (d)(4) coinsurance or insurance, and tax credits.

We will conclude our hearing with a policy discussion by a panel of individuals who are well respected in the development community and who have demonstrated a commitment to producing low income housing. We will focus on the role of the private sector, appropriate subsidy levels, the relationship between risk and return, and reforming the way that HUD does business.

OPENING STATEMENT OF SENATOR MACK

Senator MACK. Just a short one and thank you, Senator Graham. I just want to express my appreciation for your willingness to participate in what I think will be an opportunity for us to learn a little bit more about how the system works, if you will, what's good and what's bad, and we look forward to your input.

Senator GRAHAM. Thank you very much, Senator.

Our first panel will focus on the Brewery project in St. Louis, MO. We have with us Mr. Richard Baron, President of McCormack Baron & Associates; and Thomas P. Costello, senior vice president, property management of McCormack Baron & Associates.

Mr. Baron.

STATEMENT OF RICHARD BARON, PRESIDENT, McCORMACK BARON & ASSOCIATES, ST. LOUIS, MO

Mr. BARON. Thank you, Mr. Chairman, Senator Mack. It's a pleasure to be here today to talk about the Brewery project. Mr. McCormack, unfortunately, wasn't able to be with us this morning, so Tom Costello and I will certainly try to respond to your questions.

I thought it would be useful to provide a little background about the Brewery project just to put it in the context of the hearing this morning.

As you have stated, Senator Graham, the Brewery itself was originally the home of the Columbia Brewery in a structure that was built at the turn of the century. It was on the National Register of Historic Places, and was subsequently taken over by the Falstaff Brewery and for many years operated as the Falstaff Brewery in the near north side of the city of St. Louis.

Brewery operations ceased in the mid-60's and basically this structure that you're looking at remained empty and abandoned for a good 20 years before a local developer in St. Louis who preceded us with this project attempted to try to process it as a FHA-insured project and had taken some steps through the city of St. Louis to apply for an urban development action grant. The developer, unfortunately, had to cease doing business and the city of St. Louis approached us about taking over this project because it was, in their judgment, an important structure on the National Register or part of a historic district in the near north side of the city of St. Louis and preliminary estimates for the demolition of this structure approached $3 million. The stack alone was extraordinarily expensive to take down. This building has many subbasements in it and the city made a decision that it was going to try to redevelop this area surrounding the Brewery where you see a lot of abandoned land and it was very important for them to figure out some sort of a constructive use for it.

I think it's important throughout this morning's testimony to understand that our firm certainly is one of the few affordable housing developers in the country that's working on a for-profit basis. We have been active in a number of inner-city locations throughout the country. Our home is St. Louis. And we have always regarded these sorts of developments as part of an integral neighborhood revitalization process. I think it's important to understand that, that these jobs in and of themselves ought to be linked to other kinds of revitalization efforts and it was for that reason that when the city of St. Louis approached us in early 1984 about taking over this project that we felt that it was important to try to assist the city in going forward with this project because of their interest in trying to redevelop other areas within this near north side.

I think you will see from the discussion of the numbers that will follow that this project certainly was not particularly profitable. It had an enormous amount of risk attached to it and essentially what we did with it after we took this job over from the developer, City Equity, who preceded us, was to completely redesign it and we basically decided to fold in the row houses that you see immediately across the street from the Brewery to serve as units for larger families and the prior developer had already approached the St. Louis Housing Authority about getting section 8 Mod Rehab units as part of the overall financing plan for the project.

Our firm is firmly convinced that these developments wherever there is section 8 money involved to the extent that you can mix market rate and assisted units is very, very important. We are very strongly convinced that economic integration is an absolute must when you are dealing in these kinds of efforts. We are consistently talking about the need to do this and I hope at some point this morning we will get an opportunity to talk more about it on a public policy issue because in our view there's always been a certain ambivalence in Federal legislation where the Congress on the one hand continues to try to target Federal resources to the very needy while on the other hand undermines the management and good management practice that needs to follow when you're talking about dealing with low and moderate income families.

So as part of the overall mix of the Brewery of 140 units, 45 were section 8 Mod Rehab. The rest of the units are market rate in the sense that they carry no rental assistance with them, but through the various subsidies that we put together in the financing we were able to write down the rents to a level where we felt that we could attract people back to this area of the city which for many years has been devastated with demolition and condemnation actions by the city where you see largely undeveloped land.

I will just run through the rest of these slides to give you a little different perspective of it. As I indicated to you, the Brewery was on the National Register of Historic Places and this project was syndicated prior to the 1986 Tax Reform Act so that there were no low income tax credits used in connection with it, but the historic ITC and the losses and depreciation were part of the equity rates.

These are row houses as we took them in their existing condition and after the rehab. The rear of the buildings were for the most part completely torn out where drug users in many cases have gone in and taken out the copper pipes to sell and that sort of thing. This is a very typical kind of situation in inner-city property where we're working and we have to go back in and completely rebuild the rear of these structures, but they too were on the register and were preserved in order to try to maintain some of the integrity of the original architecture in this area of the city.

I think that the easiest way for us to describe the project to you is simply to refer to the tables that we have on the easels before you and to give you an idea of how the financing of this job went forward. [See Charts, I, II, and III, pp. 91-93.]

CHART I

St. Louis Place Apartments Associates
Forecast of Sources and Uses of Capital Funds

Sources of Funds

First Mortgage Loan	$ 4,800,000	4,343,400
UDAG/CDA Second Mortgage Loans	2,521,300	3,733,049
Capital contributions - Investor Limited Partners	4,440,000	4,440,000
Capital contributions - Special Limited Partner	100	100
Capital contributions - General Partners	1,000	1,000
Interest income	122,200	
	$ 11,884,600	12,517,549

Uses of Funds

Property acquisition	$ 340,000	340,932
Construction contract	7,566,500	8,994,498
Architects and engineering	450,000	655,777
Development fee and interest	366,500	(a) 350,000
Title, disbursing and real estate taxes	20,000	22,160
Interest on construction loans	279,400	177,929
Professional fees	235,000	208,797
FHA mortgage insurance premium	43,400	110,958
FHA exam and inspection fee	49,400	
Bond issuance costs	254,300	256,505
Bond discount reserve	122,200	92,900
Consulting fee - bank	135,000	
Insurance premium	100,000	137,743
Selling commissions	355,200 (b)	440,300
Financial advisory fee	88,800 (b)	
Interim loan interest and fees	363,100	427,829
Debt service reserve	456,600	
Marketing and advertising	60,000	62,494
Contingency reserve	599,200	48,392
Opening deficit		190,335
	$11,884,600	12,517,549

(a) Payable to the General Partners or affiliates of the General Partners.

(b) Payable to the Placement Agent.

CHART II

Project: Brewery

Sources of Funds:

(A) Mortgage Loan	4,343,400
(B) Equity	4,440,000
(C) Other	3,733,049
(D) General Partner Cash Investment	1,100
(E) Total Sources of Funds	12,517,549

APPLICATION OF FUNDS:

(F) Acquisition Costs	340,932
(G) Development Costs (from HUD 2330)	11,236,886
(H) Developers Fee	350,000
(I) Other Costs	1,611,266*
(J) Gross Total Applications	13,539,084
(K) Less: BSPRA (from HUD Form 2330)	1,021,535
(L) Net Total Applications of Funds	12,517,549

PROCEEDS TO DEVELOPER AT COMPLETION OF DEVELOPMENT

(M) Estimated Proceeds to Developer (E-L+H-D)	349,000
(N) Estimated Proceeds to Developer Per Unit (209 Units)	2,493

*Includes

Contractor Fee	275,000
Architect Fees	296,000
Insurance	37,000
Broker Fee (Equity)	440,000
Interest Expense	389,000
Marketing	62,000
Professional Fees and Bond Insurance	112,000
	1,611,000

CHART III

St. Louis Place Apartments Associates

	1986	1987	1988	1989
Tax Losses				
Projected	(315,000)	(905,000)	(687,000)	(703,000)
Actual	(157,000)	(835,000)	(855,000)	(671,000)
Cash Flow-Operations				
Projected	---	31,000	49,000	81,000
Actual	---	N/A	(43,000)	10,000
Historic ITC				
Projected		1,939,600		
Actual		2,290,000		

It is quite typical of the financings that we do and many other not-for-profit developers who are actively involved in inner-city locations that are trying to piece these deals together because there is no real source of financing in one place at the Federal level or at the state level, so what we wind up doing is to have to finance a project using all the different sources of financing that are available and obviously trying to stay one step ahead of the Congress in trying to anticipate which programs are going to be saved and which are scrapped and it makes life very difficult out in the trenches I can tell you that. We can certainly speak more about that.

What you see in the left-hand column is the original budget for the project as it was processed with the FHA. We have D4 mortgage insurance on this project. This was not a coinsured deal. I think it's important also to understand that.

We have for many years used the FHA process, D4 mortgage insurance, on many, many of our jobs and we have found that process in most instances in the various HUD area offices to be efficient, sensible, rational, understood by contractors, architects and developers, and with sufficient controls in place that when there were well-staffed HUD insuring offices who had career people who were part of their staff makeup we have found that it was a very good process and there was certainly accountability there and responsibility there, and I think those insuring offices, like any other offices in either the public or private sector, are as good as the people who run them, and our experience with the St. Louis area office in particular has been very, very good. We think they have done a very creditable job, certainly on our projects and many other developers who have gone through the D4 process. The Missouri Housing Development Commission will not finance without D4 mortgage insurance on multifamily projects and so there's been a very strong kind of control system in place in Missouri at least with respect to multifamily housing.

The city of St. Louis as well, since the inception of the Community Development Block Grant Program, has set aside a percentage of their annual block grant moneys to target specific neighborhoods and housing programs in particular. Their program, which they call Housing Implementation, basically provides block grant funds in a second or third mortgage position and those funds have typically been combined in St. Louis with other sources of financing that have been brought to bear on particular projects—urban development action grants, State housing finance agency reserve funds that have been injected in projects to make the numbers work.

We are in a situation in Missouri where the cost of construction and other attendant costs with a development project are pretty comparable. St. Louis is a very strong union town and wage rates and construction costs are quite typical to those that one experiences in the East or in the Far West, and the market in terms of rentals is substantially below those areas of the country. So we are constantly faced with a situation where housing costs are quite low. St. Louis is a very affordable city both in terms of rental housing and sales housing, but with construction costs that approach those in the Northeast. So the dilemma that developers have in our part of the world is that you are constantly confronted with an enormous gap between the total cost of development and what you can get in the way of income. So that differential has to be made up in some form or another if deals are going to get done.

In the case of the Brewery, there were $4.8 million worth of tax-exempt bonds that were issued and in this case they were actually issued through the Redevelopment Authority of the city of St. Louis. Half a million dollars was held as a debt service reserve so that it was actually $4.3 million that was used as first mortgage proceeds for the project and there was a second mortgage on the property that initially was estimated to be about $2.5 million that was a combination of Urban Development Action Grant funds along with the Block Grant funds through the city of St. Louis that I described.

Those funds that were injected into the Brewery project represented a writedown for the actual housing itself as well as paid for the public improvements that surrounded the Brewery—the sidewalks, the streets, the relining of sewers, street lighting, and the like. And the syndication of the project was successful. We raised $4.4 million. This was again pre-1986 where we were able to use the investment tax credit, the ITC, and had accredited investors in this deal. [See Chart I, p. 91.]

You see the uses of funds below and I think what's important to note is that there were substantial increases in the construction contract. About a million and a half dollars of additional funding was required because of the condition of the Brewery. And one of the things that we did when the city asked us to step in and participate in this project was to get them to agree that to the extent we found some very severe latent conditions in the structural systems of the building the Brewery proper that the city would be there to backstop it because it was a situation where we had no ability to do any kind of preconstruction investigation. The highest point of the Brewery was about 13 stories and there was no lighting in there. There was no ability to see. What we had to do, once we got into construction, was erect a massive scaffolding system in the inside of the Brewery and go into these 15-foot stone walls to explore the structural steel. What we found was that through the fermentation process in the main brewhouse of the Brewery there had been substantial deterioration of the steel members that had to be replaced. That accounted for the very significant increase in the construction costs.

You will see that the development fee originally was projected at $366,000. We wound up earning a magnanimous sum of $350,000 for a $12.5 million project—hardly what one would call a significant return. This job I'm glad to report is not typical of what we do in terms of profit, but it certainly was an effort that we felt was necessary to make for the city and it was important to try to combine it with the section 8 Mod Rehab Program along with the other sources of financing that were necessary in order to make the project work.

So that in summary, I think that it's important to note that we were well-served by the HUD area office in terms of their D4 mortgage insurance. We had a very stringent review of our construction costs and our plans by the city of St. Louis through their community development block grant office and certainly through the housing authority in terms of its oversight through the section 8 Mod Rehab Program.

I think that the section 8 program worked well in this situation. Particularly, we combined it with market rate units. We have taken individuals off the waiting list of the housing authority and while we are only talking here about 45 units, 140 overall, I think that in these kinds of situations where you have projects that are financed jointly by local governments, State government, Federal Government, the kind of abuses and the various projects that this committee has been investigating and have been written about generally don't involve real serious neighborhood revitalization efforts and community redevelopment efforts where you have a public-private partnership working between private developments and local government, State government and Federal Government and where there is a genuine interest in trying to improve neighborhoods.

I think in those instances the section 8 program, as far as we know and from our own experience in using the section 8 new construction program as well as the Mod Rehab and substantial Rehab programs, worked very well. There is accountability in the system. Professionals at all levels have joined with us and our staff to bring these projects to fruition. And we are subsequently monitored through the HUD area office's management division. Tom Costello can address those issues this morning. There is constant management review of the property maintenance by the HUD area office. There's a replacement reserve that's required as part of the HUD underwriting process and it's a situation where, if there's positive intent to make these things work, they work fine. And I think if somebody sets out to abuse the system, the system will be abused. I think that to the extent that these funds are targeted in a way to support and reinforce efforts of a local community, regardless of where in the country, they can be quite successful.

We found that with the Brewery. The project has rented up. We have been at about 90, 92, 93 percent occupancy. We are in a period now where because of the winter and some move-outs we're down around 91, but we expect it to pick up in the spring. The project has been very well received and the important thing about it is is that it took a very, very large structure that would have sat and just simply deteriorated over time because the city could find no positive benefit in spending $3 million to tear this structure down and we've turned it into 140 new housing units. We started a process of revitalizing this near north side of the city and at some point, if there are sufficient funds finally that come through Washington to the city of St. Louis in some of these programs that have been so badly emasculated over the last 10 years are restored at some point, there's some hope that we can move forward in these neighborhood revitalization efforts.

But in substance that's essentially what the Brewery project involves. There are some other tables talking about the tax losses and the cash flow from operations and the historic ITC that really go to the question of raising the equity in the deal, but I'm not sure that they are that relevant for this morning's purposes but we would be glad to respond to any questions you might have. [See Charts, I, II, and III, pp. 91-93.]

Thank you.

Senator GRAHAM. Thank you very much, Mr. Baron.

Mr. Costello.

STATEMENT OF THOMAS P. COSTELLO, SENIOR VICE PRESIDENT, PROPERTY MANAGEMENT, McCORMACK BARON & ASSOCIATES, ST. LOUIS, MO

Mr. COSTELLO. I really have nothing to add on other than to indicate that the Mod 8 Rehab rents that we received at the time were processed at 110 percent of the market rate units in the city of St. Louis. Just for everyone's understanding, the Mod 8 rents were $390 for a one-bedroom, $450 for a two-bedroom, $546 for a three-bedroom. In 1990, the rents now have gone up to $425, $477 and $591. The rents have only risen approximately 9 percent over a 2-year time. So it's well within normal operating costs and as Mr. Baron said, we have tried very hard and very diligently to management this project. It's a racially mixed project now. It's 80 percent minority, 20 percent majority families live in the units.

One of the things that we try to do—this is in an isolated area of north St. Louis which has been overall a very depressed area, and we have done very stringent leaseup techniques. For example, we have home visits to all the prospective tenants, the applicants, who want to come into the units. We screen them very carefully. We monitor their credit and the normal police credits that most companies do, but we do strive with this home visit we actually have our people go out and visit the home of the applicant so we can see what kind of an environment they are coming from, if there are any social problems we try to take care of them in that situation.

As you can see, the operating costs cash flow has finally gotten stabilized. We are just starting to break even at this point. We are marketing in a very difficult area. This area is approximately two blocks away from the Pruittigo project which I'm sure everyone in the country knows about. So this gives you an idea of the area that we are marketing in. It's a well-maintained property. We are very proud of it. We will show it at any time that anyone wants to see it and I think there's been a lot of people who have seen it who are very pleased with it.

That's very generally all I can say at this point. I'll be glad to answer any questions that you may have.

Senator GRAHAM. Thank you very much, Mr. Baron and Mr. Costello. Your testimony has been very helpful in understanding how these transactions are assembled.

I would like to ask a few questions. Normally we have a series of lights which tell us when our 5-minute questioning period is up. Our lights are missing today so Mr. Leary is going to let us know when we have used up our time and we will rotate through the members of the committee.

We have now been joined by Senator Bryan from Nevada. Senator, if you have any opening statement to make before we turn to questions, we would be pleased to receive them.

Senator **Bryan**. Mr. Chairman, in the interest of time, let me just ask that my opening statement be made a part of the record.

Senator **Graham**. Thank you, Senator.

OPENING STATEMENT OF SENATOR BRYAN

Senator Bryan. Mr. Chairman, I commend you for holding this hearing this morning. For the past several months, we have heard testimony from the HUD inspector general, former and present HUD officials, and members of the private sector about lucrative "deals" that were put together by knowledgeable and well-connected individuals making profit from affordable housing programs designed to assist low-income individuals. I think it is important to ascertain how these "deals" were put together and how programs intended to help the poor, actually profited the wealthy and influential.

I am also pleased to see Mr. William Cottrell, the executive director of the Clark County Public Housing Authority, from my home State of Nevada, here today to talk about the Sierra Pointe Housing Project. Mr. Cottrell can learnedly discuss the involvement of the public housing authority in determining the various aspects of HUD-assisted housing projects and his own frustration in working with the HUD central office in Washington.

Mr. Chairman, I look forward to hearing the testimony of our witnesses today.

Senator **Graham**. How many different agencies did you deal with in putting together the financing for this project?

Mr. **Baron**. Well, I think that we can simply—the City Redevelopment Authority, the city of St. Louis utilizing its block grant program, the area office of HUD, the UDAG office of HUD Washington, and obviously the private firm that syndicated the project for us that was based in San Francisco.

Senator **Graham**. What was the sequencing of the government agencies and how much did each of them know as to what the other agency was providing in terms of subsidy?

Mr. **Baron**. Well, the sequencing was really a simultaneous kind of situation. The city of St. Louis—the first submittal was to them. Simultaneously, an application had been submitted to the St. Louis Housing Authority for the Mod 8's. The application for mortgage insurance went in. The request for the Urban Development Action Grant had been submitted to Washington. And all of the parties to the transaction were well aware of all of the other parties to the transaction. Meetings had been held with all of them brought together and everyone understood that they were going to participate in the overall financing of the project.

So there was complete communication. All the documents were shared with each of the agencies and we were really the catalytic agents for the project and it was our staff that was basically responsible for bringing everybody together to make sure that there was a coordinating kind of role going on and we were providing the information to everyone and making sure that people were communicating with each other.

Senator **Graham**. Just to elaborate on that statement, for instance, when the UDAG grant was being structured, it was done in recognition of and consistent with the other elements of the financing that had been put together previously or were being accomplished simultaneously.

Mr. **Baron**. Absolutely. And of course the requisite "but-for" letter had to be submitted to UDAG with all of the other financing commitments there and an indication that the D4 mortgage insurance was going to be in place. So all of that was there, Senator.

Again, from our experience, we had an excellent relationship with the UDAG office at HUD Washington. It was an excellent program that worked beautifully. I think we have received 12 or 13 urban development action grants for low and moderate income housing in different cities around the country through HUD Washington. Certainly in the 20 years that I have been involved in the field, I think that program was probably one of the best that was ever in place in terms of really providing the necessary catalytic funds to get some of these kind of jobs off the ground and working.

Senator **Graham**. Could you tell us how the rent level was established for the 45 section 8 units?

Mr. **Costello**. That was handled through the housing authority and was coordinated quite closely with the HUD area office. The HUD area office had established what they called the fair market rents. The housing authority was entitled to go up to 110 percent of those fair market rents.

In our case, we had to support and justify asking the housing authority to go up to 110 percent, which they did. They did that only after we certified our construction costs and we went through an exhaustive working with them showing what our costs were on the rehabs and what-have-you. When that was done, they allowed us to increase the rents up to the $390 level that I mentioned earlier.

It was a process of a lot of negotiations. They did not accept everything we said. They went and actually visited the project, the construction site. They monitored the construction to make sure that the work was done satisfactorily for their purposes. It was well looked at by the housing authority. When they were done with it, the HUD area office also had their inspection and they concurred in it.

I might point out that that process is quite lengthy. I think it's a good process. I think it does discourage some developers perhaps, but I think from the standpoint of the housing authority and HUD they were only protecting their interests and we felt that that was something we had to go through. I just point that out because a lot of people on the private side tend to blame the bureaucrats for unnecessary delays, et cetera. We even had some in-house problems with our engineers because they were frustrated with the housing authority people.

But overall, on balance, I felt that the housing authority people were trying to protect their interest. I think they did. I think it was a well-thought-out deal. There was no undue pressures on anybody and that's the way the deal felt and I think it would stand any scrutiny of anybody who wants to look at it.

Senator **Graham**. In looking at some of the information that you provided us, we have some data on your rental rates. There is no date on these numbers and maybe as I read them you can tell me what period of time these were applicable.

You were renting 40 one-bedroom units, 670 square feet each for $350 a month.

Mr. **Baron**. Those were the initial projections, Senator, when we came on-line.

Senator **Graham**. I was curious that the section 8 one-bedroom which were 130 square feet smaller, had a $7 a month higher rental rate. What was the reason for that?

Mr. **Baron**. Well, the initial processing of the market rate units and the section 8 units in terms of how those two programs interacted with each other resulted in that situation. On the one hand you're looking at market comparability with a D4 mortgage trying to introduce market rate housing into an area that hadn't seen any in probably 30 years and trying to attract more middle income people back into an area, and combining that with section 8, which program has its own method of arriving at what the fair market rentals are for putting housing units onto the market at a particular cost.

So there was some difference in the market rate units versus the section 8 units. The reality of it is is that the overall project was designed to try to penetrate an area that had nothing but lower income families, welfare families, public housing eligible families in it, with market rate tenants, which we have been successful in doing, and it's simply an anomalous situation when you're trying to do a combined section 8/market rate job that's processed through the D4 mortgage insurance program that that kind of thing happens. It's typical and it relates basically to the way the section 8 program works down one track and the D4 mortgage insurance program works down another where the underwriters are making sure that the project has enough cash flow to service debt and the section 8 program rents are set by a local housing authority that's not involved in the underwriting process who are providing mortgage insurance. That's why the difference.

Senator **Graham**. My time is up. Senator Mack.

Senator **Mack**. Thank you, Senator Graham.

First of all, let me compliment you on the outcome of the project. It looks like I hope I will have an opportunity when I'm in St. Louis next time to maybe come by and take a look at it.

Mr. **Baron**. We would love to have you.

Senator **Mack**. I've had the opportunity during this last year to travel around our State quite a bit and look at the different projects and it is amazing the range of success and failure. So I compliment you on your success.

Mr. **Baron**. Thank you.

Senator **Mack**. Let me just touch on a number of different areas. Again, you commented about the fee of $350,000 is something you're not terribly proud of. It sounded, though, that you also knew going in that this was a project that maybe was not going to develop the kind of return that you would normally look for.

Could you just share with me maybe two points there. One, what in fact motivated you to get into this; and second, what would you normally expect from a profit standpoint to have been able to have come out of this project with?

Mr. **Baron**. Sure. Well, Senator, I think that the Brewery is very instructive in terms of responding to your question.

What motivated me originally for getting into it is what I addressed early in my remarks, which was that the city was interested in seeing this area stabilized and some new housing introduced and as part of a redevelopment effort on the near north side of the city they really had no way to work around the Brewery. It's a massive structure that was sitting there and, as I said, the preliminary demolition estimates to take it down were upward of $3 million and the city just simply could not justify taking that kind of money out of a very meager budget and demolish it and wind up with more vacant land.

So that in terms of infusing dollars to the extent they could use their block grant funds as a positive kind of financing source, as they have here, and put a mortgage on the property and have some expectation down the road they might get it back and in addition get 140 units, plus the market rate units, it made sense. And we were willing to go forward with the city because we also had an interest in seeing this happen in the city. We are based in St. Louis and from time to time we will do this kind of thing.

Senator MACK. Let me hop in here just for a second if I could. What is maybe unique about this is again there was a deep interest on the part of the city. This was not a project where—I guess the incentives alone that normally would be available to you—it was more than that. The city really had a real interest in doing something with this property and, as a result of the city's willingness to use every one of their resources available to them, it really put you in the position to make the project at least marginally profitable.

Mr. BARON. That's correct. And, Senator Mack, you could just look at the construction costs, in the first column we initially went in with a sense from estimates before we had a chance to do the structural investigation that it was going to be about a $7.5 million job wound up almost $9 million. There was a $1.5 million overrun in the construction and it was the one area where I had worked out an understanding with the city because I said, "Look, we can't possibly take that risk." [See Chart I, p. 91.]

Well, assuming the numbers that we had in column one with a profit forecast there of $366,000 and with a $1.5 million overrun, we would have lost $1,200,000 because as developers we are providing construction guarantees to the limited partners as well as operating deficit guarantees. So if we had done this deal and gone forward on the basis that as it turned out we would have lost an enormous amount of money.

Senator MACK. Well, the odds are you probably wouldn't have gone into the deal if you couldn't have worked that out.

Mr. BARON. You're absolutely right, and I was willing, with that backstop, the city traded me fee for that guarantee in effect. So for $350,000 which basically paid for our overhead time and watching this thing go forward for 3 years with all our staff people and everybody else out there, plus I still had to provide the operating deficit guarantees to the investors in a very, very difficult area of the city, I was willing to take that risk because the city was willing to join me in that partnership, which happens often in communities around the country.

A typical return that I would have expected if I had done this deal as a stand-alone, if you could have even made the numbers work, which you couldn't have in terms of a private sector kind of an approach, is somewhere around 12 to 15 percent for a Rehab project of this magnitude and of this size. That's what we would typically have expected. So we would have hoped to have realized a profit of somewhere around $1.2 million to $1.5 million that would have been paid in over a 4-year period out of which we would have had to pay for the overhead cost of our architects and engineers who monitored the project along with the general contractor who's there and the architects we retained.

So netting it out, if we could have realized a $½ million of real profit on the thing, that probably is about what one would expect.

In a new construction job, where you are not talking about the kind of risk that you take with substantial rehabilitation of a structure like this, I would say that a profit of 10 percent or so is generally what we are looking for, 10 to 11 percent is what we're looking for when we do a deal that's new construction of a vacant piece of land even where the city is participating with us. There's still the marketing risk and the construction risk and it's necessary just in terms of the overhead of our staff overseeing these jobs as we go around the country, out-of-pocket expenses and the like.

Senator MACK. Tell me again. I appreciate you covered this in your opening comments, but what was it that the city was willing to do to protect against unknown costs?

Mr. BARON. They were willing to cover up to about another $1.3 million they told me of structural costs to the extent that it emerged from the investigation process once we started construction and, indeed, it came out to that.

Senator MACK. And those funds came from CDBG?

Mr. BARON. Correct.

Senator MACK. My time is up.

Senator GRAHAM. Senator Bryan.

Senator BRYAN. Thank you very much.

Mr. Baron, it was not clear to me, although the city had a great interest in rehabilitating this neighborhood, how you became involved in this project initially.

Did you come to the city and say, "Look, I think we can make something out of the old Brewery," or did they approach you and say, "Look, we'd love to have you with your background and expertise put together a package and let us take a look at it?"

Mr. BARON. Senator, I had said in my opening remarks there was a former developer that had tried to do this and he had gone bankrupt.

Senator BRYAN. I see.

Mr. BARON. And the city came to us as a local developer in the community that's done a lot of this type of thing and said, "Would you be willing to take it over?" That's how it happened.

Senator BRYAN. A question about the development fee and interest, $366,000. You've been involved for a good many years I gather in this type of work. How does that fee compare with the fees that you have received or those who are in a similar business in the metropolitan St. Louis area compare?

Mr. **Baron**. It's very low and for a project of this complexity with the kind of risks attendant to it, it's extraordinarily low. As Senator Mack indicated, if it hadn't been for the city's willingness to backstop the construction, we would have never gone forward with the project.

Senator **Bryan**. Now looking at the sources of funds there, you have capital contributions of $4.4 million, $2.5. [See Chart I, p. 91.] Does that represent out-of-pocket cash or is that just an accounting capital contribution calculation?

Mr. **Baron**. That's proceeds raised from the syndication from limited partners, Senator. This was a pre-1986 deal, back in that era that's now a part of history. This job was syndicated with accredited investors.

Senator **Bryan**. So we're talking about real dollars, Mr. Baron, not just an accounting calculation?

Mr. **Baron**. Absolutely.

Senator **Bryan**. OK. In a followup to a question the chairman asked about the calculation of fair market rents, did the local housing authority agree with that calculation? Did the region agree? We've had a lot of comment, as you know, prior to your arrival here in previous hearings that there's oftentimes a gap between what the local agency that's involved feels is a fair market rent as opposed to what is ultimately approved at the Washington level.

Mr. **Costello**. To our knowledge, it was approved by everyone. As I indicated, the housing authority was the entity that we dealt with in negotiating out the costs and getting them to approve 110 percent of the fair market rents.

That was also approved by the HUD area office. To the best of my knowledge, there was no difference of opinion by any of the other HUD offices. Everybody concurred in it. And the contract was signed accordingly.

Like I said, it was a very thorough and meticulous look at our costs and everything else by the housing authority and then later was done by the HUD area office. Both of them agreed and there was no difference that we are aware of.

Senator **Bryan**. Let me just try to nail that down if I may. Mr. Costello, if I understand your testimony, you are indicating that at no time were you aware of any internal disagreement, either by the local housing authority, the region, or Washington in terms of what the fair market rent on this project ought to be calculated at.

Mr. **Costello**. I was not aware of any. Like I said, again repeating, they had the fair market rents. Our concern was to get those up to 110 percent.

Senator **Bryan**. I understand that.

Mr. **Costello**. But there was no disagreement that we were aware of.

Senator **Bryan**. So insofar as you know, everybody was in sync or agreement on what that calculation as it related to this project ought to be?

Mr. **Costello**. Yes.

Senator **Bryan**. And finally a question—having gone through this whole thing before, what specific recommendations would you make to us as an oversight body in terms of improving these kinds of projects from the standpoint of administration, of getting a project that actually works as attractive to the private sector?

Mr. **Baron**. Well, I think that there has to be some—I think it starts at some sort of a national level, Senator, with a commitment to do some housing. I think that to the extent that there is some interest in seeing these kinds of projects go forward, these neighborhoods revitalized, dealing with the problems that I think all of us are aware of that are going on in the cities throughout the country, there has to be some national commitment to housing. And that's not evident, has not been, and I think that part of the problem that one finds with these programs is that, because there is no clear, consistent way of dealing with financing them, you have to go through this patchwork quilt of financing to make deals work, you're forced into finding financing at all levels of government and through the private sector. I think when one steps back from the Brewery project, it took 3½ years to develop 140 housing units and there are 10,000 people on the waiting list at the St. Louis Housing Authority. I think it speaks for itself.

And where there is no interest at the national level and no commitment on the part of an administration to see any kind of housing done, then all the problems ensue. The good people leave. The HUD area offices throughout the country have simply been emasculated. There's no more interest in these area offices. A lot of the good people left. I think that Secretary Kemp is making an effort now, but I think that the reality of it is that I don't know where you find the skills. Many, many of the good people have gone on early retirement and people who were really committed to trying to do affordable housing and work through the FHA process have left now because they just felt that there was no interest in the Government to really see this kind of thing go forward.

And the financing has been completely destroyed. The UDAG program is gone. There's no clear kind of national financing program available like the old GNMA tandem program.

So I don't know what one expects. I mean, when you leave the local communities in the kind of disarray that they are in now with no clear national purpose, abuses are going to follow and it's just sure as night and day. The private sector, where there are people that aren't really committed to doing this kind of work, will swoop in and take advantage of the vacuum in the system and there will be abuses. Whether or not there's really some sort of national commitment to this is something that I think all of us on the outside are waiting to see. Certainly it's not been evident up until now in the last 10 years.

Senator **Bryan**. Thank you, Mr. Baron. My time is up, Mr. Chairman.

Senator **Graham**. I think Mr. Costello wanted to say something.

Mr. **Costello**. I was going to add to that if I may, Senator, I think it's also important that the Government, whether it's the Federal or local government, also follow up on the long-term management of the projects.

One of the things that I think that over these past many years this country has produced a lot of housing. This country has not managed much of that housing very well and I think in the long term projects like these that are isolated are going to require a tremendous amount of management input and constant vigilance to keep these projects up so that we are all proud of them.

This is one thing that goes amiss real quick and it doesn't have the glamour of the production of the project and the development, but 2 or 3 years down the line people will drive by those projects and wonder what the hell happened. I think there has to be some effort to structure up the management component so that it serves the long term interest in the project.

Senator **BRYAN**. One of the bright spots—I might say by response, Mr. Costello—in terms of good management, the chairman has scheduled Mr. Cottrell from Clark County. He will be testifying. That's an example of projects that are very well-managed and I'm sure you would concur that ought to be a model for a lot of other projects.

Thank you, Mr. Chairman.

Senator **GRAHAM**. Thank you, Senator.

Forty-five of your units were section 8 units. Is that correct?

Mr. **BARON**. That's correct.

Senator **GRAHAM**. Of your total development costs of almost $9 million, do you know how much of that was applied toward the rehabilitation of the 45 section 8 units?

Mr. **BARON**. Senator, we really don't have a way of identifying that because of the fact that we try to integrate the section 8 units and the market rate units within the total development. In other words, the income stream from the section 8 rents and the market rate income stream is all part of the financing equation, if you will, and one of the things that we have insisted on where we have done mixed income developments is to have economic integration and not isolate the section 8 units from the market rate units to create that kind of pressure within a community and to somehow target the lower income families so that we can't really give you that number.

The only thing we can tell you is the total Brewery costs so much in construction and the section 8 units have exactly the same finishes, the same amenity levels. There is no difference at all in those units and the market rate units, which is again part of the way McCormack Baron has done its deals. You can't walk into a section 8 unit and a market rate unit and see any difference whatsoever. And the tenants themselves have no knowledge of who's there.

So I don't know quite how to respond to you other than to say that the section 8 units were built under the same construction contract as the market rate units so they are in the total complex, scattered throughout.

Senator **MACK**. This is not a financial question. It's more just the makeup of the project. Are the 45 units that are section 8, are they separated from the others or can one unit be side-by-side to another?

Mr. **BARON**. They are scattered throughout, Senator. In other words, in the hallways, apartment 201 could be a section 8 unit and apartment 202 could be a market rate unit and we have done that in every situation where we have mixed income developments which we try to do because we find from a management point of view and a community point of view it's a much better approach than trying to do all assisted units in one complex and in terms of the management and the longevity of these developments, as Tom has just indicated, it makes a great deal more sense.

Senator GRAHAM. Looking at that $9 million figure, I'm trying to convert that down to cost per unit, and if you just divide it by 140 units you come out at roughly $65,000.

Mr. BARON. That's correct.

Senator GRAHAM. Is there anything that needs to be factored out of that before you go with a straight division, or is $65,000 a unit a reasonable estimate of what it costs to develop a unit?

Mr. BARON. That's the number.

Senator GRAHAM. The question I had is, this program, Rehaberate Rehabilitation, the emphasis was on the word "moderate." The initial concept was that it was going to be for relatively smaller scale rehabilitation. The number $10,000 was a figure used when this program was initially developed.

I'm surprised that a project of $65,000 a unit was funded through the Rehaberate Rehabilitation Program. Did you explore some of the other HUD programs that dealt with more extensive rehabilitation before you got to Rehaberate Rehabilitation as your funding source?

Mr. BARON. Sure, Senator. They were all cut off. They weren't funded any more.

Senator GRAHAM. So this was the only game in town?

Mr. BARON. You got it, and the only way you can make these deals work—you saw the condition of those row houses before we took them over. You go through a city like St. Louis or many other cities throughout the United States and in terms of the neighborhoods you can't find units to rehab for $10,000 a unit and put people in in many, many cases.

If you're talking about trying to get housing done and revitalizing neighborhoods as opposed to trying to find the needle in a haystack where you find a six-plex that you can use the Mod Rehab Program with, then you're lucky enough to do that.

One could argue, well, you oughtn't to use section 8 mod rehab for doing the Brewery and you shouldn't have done it and you should have just let it sit there, and I suppose you could argue that. But in this case there was a real clear redevelopment strategy that had been initiated by the city of St. Louis and they wanted to see this thing done and they came to us and we were willing to participate so that section 8 Mod Rehab Program was one piece of a very intricate kind of financing program that ultimately got the thing built.

Senator GRAHAM. This subcommittee's particular focus is on the Mod Rehab Program.

Mr. BARON. I understand.

Senator GRAHAM. And those programs which are layered around it. As a policy matter, would you suggest that there should be a program particularly directed at the large-scale—it's almost inappropriate to use the word rehabilitation because you essentially were building new units in a structure that had previously had a different use.

Mr. BARON. That's correct.

Senator **Graham**. If you were writing national housing policy, what would you suggest would be the most appropriate in terms of meeting the public goal of providing housing for low income families, meeting a community goal of enhancing or stabilizing a particular neighborhood, and making it attractive enough financially for private investors to participate?

Mr. **Baron**. Senator, I think what I would do is I would probably look to maintaining some sort of a rental assistance program like section 8, but I think that the time has really come to take a look at housing policy as it works throughout a local community, both for low income and moderate income people, and I would think that the most sensible way to approach it would be to do some sort of a block grant for housing and allow local communities and State governments to ultimately decide how to take on the issues of sites like the Brewery, new infill public housing, modernization.

I think that what's happened in the Government is the bifurcation of these programs in different agencies of HUD, the anomalous way that public housing is funded under the Housing Act of 1937, I mean I think the time has really come to do what the Congress did back in 1974 with the Housing Community Development Block Grant Act with all the categorical grant programs finally getting lumped together and some hold-harmless given to the cities with some regulations put in place to continue to target those funds to low income and moderate income, and let the local communities decide how they are ultimately going to use those funds.

I think there has become a fairly sophisticated professional group of housers at both local levels and State levels, particularly through the housing finance agencies who have been in the business now for quite a long while, and I just think that the kind of machinations that one has to go through as a private developer to get involved in these projects is so discouraging that by and large most have left the field and we are really committed to it and have stayed in the business, but I think you have to simplify it.

I don't think that you are ever going to be able to oversee all of this. I think you must be just weary of all of the complaints about not having enough money for public housing modernization and all the rest of it and I think it's time to push it down to the local communities and let them decide. If they want to spend $60,000 a unit on rehabbing a Brewery and put in low income families and build new and have some funds that they can use interchangeably for neighborhood vitalization strategies, I would combine it with the block grant in some way and write some good tight regulations so that low income families are not displaced and not basically overlooked, and I think that we just can't continue to try to fund at $1.8 billion in mod and $1.8 in operating subsidies these public housing sites that were built in the 1940's and 1950's. It's kind of like retrofitting a 1954 Studebaker for 40 years. They are out-of-date. They are obsolete. There are a lot of better ways to house families.

Management techniques have grown up now with a lot of community-based organizations of which there are many, many excellent ones, thousands of them throughout the country. There are all kinds of new things that have been done successfully and I think that's what I would do, Senator. That's sort of a long-winded response, but I would get out of the business now of trying to write special legislation for section 8, Mob Rehab, public housing mod, operating subsidies, and provide a housing block grant to the cities, work out some kind of fair formula, kick it back down to them and let them decide how they are going to run their own lives because what works in Dade County may or may not work in St. Louis city or County or in Los Angeles or San Francisco.

Housing is a very specialized kind of business with some markets within communities and I don't think that Congress or people in Washington are really smart enough to figure out how to do it all and I think from the private side you would get a lot more interest if developers and not-for-profit community-based organizations knew they had one place to go and they would work out their arrangements, just like they've done with the block grant program.

Senator GRAHAM. Thank you very much, Mr. Baron, for an excellent, insightful response.

Senator Mack.

Senator MACK. Thank you.

Let me go back to the funding mechanisms for just a few minutes.

The first mortgage loan, did I understand you to say that those were tax-exempt bonds?

Mr. BARON. Yes, sir.

Senator MACK. Tell me a little bit about those.

Mr. BARON. Well, they were just redevelopment authority bonds, housing bonds, that were issued into the market prior to 1986, and they were just simply purchased through a bond issuance by a local municipality.

Senator MACK. There again, the ability to raise that $4.8 million was because of the tax-exempt status of the bonds?

Mr. BARON. Sure, and the FHA mortgage insurance, absolutely.

Senator MACK. That's the D4 that you were referring to?

Mr. BARON. Yes. Absolutely critical.

Senator MACK. The D4?

Mr. BARON. Yes.

Senator MACK. You've made a point of that. You've mentioned it several times. Frankly, I'm not that familiar with D4 compared to coinsurance. Tell me what the significant difference is.

Mr. BARON. Well, the coinsurance program basically privatized the FHA D4 mortgage insurance program on the theory that the private sector could do it better than HUD and it would save money. It would be more efficient. So much for that approach. I think that it worked in some cases and then there were a lot of abuses, as you all are discovering every week.

The importance of the mortgage insurance is that the full faith and credit of the Government stands behind the bonds and if there's a default——

Senator MACK. In addition to the tax-exempt nature, the holder of the bond knew it was guaranteed?

Mr. BARON. That's correct. And in terms of the interest rate differential between a noninsured bond that's sold out in the marketplace for a project like the Brewery, there would theoretically be a market, but at an interest rate that would be so high that you could never make the numbers work. So that having the D4 mortgage insurance drives the rate down to a level where you can integrate the bond financing with all the other elements of it.

Senator **Mack**. So in addition to the city's commitment to basically whatever program that they had available to assist this project, we basically had two major Federal subsidies, if you will—the tax-exempt status of the bond and the guarantee that brought the interest rate down?

Mr. **Baron**. Correct.

Mr. **Costello**. We also have the tax credits.

Mr. **Baron**. Not in this deal. The historic credits you mean?

Mr. **Costello**. The historic credits. That's also involved.

Senator **Mack**. Now that investment tax credit came in in the sense of being—tell me about the $4,440,000.

Mr. **Baron**. There was a 25-percent historic tax credit that was part of the equity raised that investors in effect got the credit.

Senator **Mack**. Tell me so that I understand this if I were an investor. If I wanted to buy one of those—was it a $100,000 limit?

Mr. **Baron**. Units, whatever it was. They were $100,000 apiece.

Senator **Mack**. I'm an investor. What is the sales pitch to me to get me to buy that?

Mr. **Baron**. Pre-1986 what was the pitch?

Senator **Mack**. Yes.

Mr. **Baron**. Well, essentially it was that with the $100,000 investment there would be the historic tax credit that would basically in the early years of the pay-in shelter that investment to a point where the investor would have very little money in the transaction because of the tax credit that he could take or she could take against his or her personal income. Thereafter, with that shelter, they were willing to put in the additional capital.

Senator **Mack**. Say that to me again. What that sounded like was, I think Senator Bryan asked earlier was this just an accounting or was this real cash.

Mr. **Baron**. It was real cash.

Senator **Mack**. I understand. But again, from the point of view of the investor, I thought you said something like, well, I really wouldn't have too much up-front in it.

Mr. **Baron**. Well, you would theoretically put in $50,000 and you would have close to that in terms of the historic tax credit that would be available to you because it would be taken in the early years of your pay-in so that you were sheltering your investment, if you will, against your personal income.

Senator **Mack**. I understand.

Mr. **Baron**. And that was the thing that Congress wanted to do away with.

The important point to make about it is that you have in this project and many others across the country an area that was devastated over the last 20 years and you have $4.4 million of private individuals who were willing to put in equity into a project——

Senator **Mack**. Again, my point is, they were willing to put that equity in because it was a tax write-off.

Mr. **Baron**. Sure. It was a shelter. Absolutely.

Senator **Mack**. I'm not arguing with that. I'm just trying to make sure we all understand.

Mr. BARON. That's exactly right, with some expectation or hope that there might be some cash-flow or there might be some up-side on this thing 15 years later upon sale or refinancing. But primarily, their willingness to put the money in was because they had a sheltered investment.

Senator MACK. So again, we have the $4.4 million that is guaranteed. It's tax-exempt, lower interest rate because of the guarantee.

Mr. BARON. Correct.

Senator MACK. We have the UDAG and——

Mr. BARON. Block grant funds.

Senator MACK. And block grant funds which come from the city which came from——

Mr. BARON. And Washington.

Senator MACK. From Federal subsidies.

Mr. BARON. Right.

Senator MACK. And the $4.4 or $4 million you were able to get that in because of the tax shelter provisions in the tax law.

Mr. BARON. That's correct.

Senator MACK. That's all leading me to this question—and it's not whether you should have done the deal or not. I'm trying to make a judgment from my own perspective about whether this is the proper way to get low income housing, if you will, is to do all of those things—and I can't equate exactly at this point what that dollar amount is—to have 45 units out of 140 that are in essence—which is roughly a third I guess—that are set aside for low income housing.

Let me just make a last comment related to this. The question that really goes through my mind is, is this really the most effective and efficient use of tax dollars to provide low income housing? Without getting into the value of the project and the value to the community, how do you respond to that?

Mr. BARON. I respond to it the way I did to Senator Graham. I think that it is the most convoluted way imaginable to deliver low income units with a waiting list of 10,000 people at the St. Louis Housing Authority. It's preposterous. But that's what we've been left with, Senator.

Senator MACK. I understand. Please don't——

Mr. BARON. You're not going to hurt my feelings.

Senator MACK. OK.

Mr. BARON. I've been at this too long. I had a full head of hair like yours when I started.

Senator MACK. Then I'm going to stay on this side.

Mr. BARON. Absolutely. Don't go into this business, Senator.

Senator MACK. Again, to just underscore the point, we try to come at this that this was a good deal. This is a typical good deal, if you will, which the more and more I look at it the more and more I conclude, while it is a good deal, it is not typical.

How many of these projects have you done?

Mr. BARON. Forty.

Senator MACK. Forty just like this one?

Mr. BARON. Well, they are more or less as convoluted.

Senator MACK. Out of how many that you've done?

Mr. **Baron**. We don't have any easy jobs because we are working in neighborhoods across the country where they are just impossible to do and nobody else is willing to go into the areas where we go.

Senator **Mack**. OK, but wait a minute.

Mr. **Baron**. In terms of the financing arrangements?

Senator **Mack**. Yes.

Mr. **Baron**. Is that what you're asking? I would say that this is fairly typical of what we do.

Mr. **Costello**. We've got 37 or 40 deals like this. This is the only way you're going to build housing under present laws in the inner-cities and that seems to be the niche that we are in, rightly or wrongly.

Senator **Mack**. And do you have a mix in all of them like you were talking about?

Mr. **Costello**. We try to.

Mr. **Baron**. We try to, Senator. Absolutely. And I think it's important and the only thing I would raise in connection with your observation is that you're really not looking just at 45 units. You've got to look at the 140, Senator, because it's very important as a matter of policy locally to start to economically reintegrate these neighborhoods. And the market rate rentals that we talk about are really written down substantially in order to induce higher income families to come into this area. So what our market is is basically from people who would be Section 8 eligible up through $40,000 or $50,000 of household income with a husband and a wife working at a minimum wage level or just above, and that's the target population.

One of the other things that concerns me greatly is that the only tool that's available now to raise equity for multifamily housing are the low income tax credits and Congress has put a cap on the eligible incomes there of 60 percent of median income, again because of this concern that somehow higher income families are going to benefit through these laws.

In effect, what we're doing is cutting off our nose to spite our face. I mean everybody understands the horrendous management problems that local housing authorities have because all of the families are large and low income, and yet we turn around with a tax credit program and we restrict the incomes of people who can live there so there's virtually no way to raise private equity except through the use of the tax credits, and we've said that only people with 60 percent of median can live in those complexes. So you've turned right around and done exactly the same thing that everybody is struggling with now in terms of large family public housing in terms of the management issues. On the other hand, Congress turns around and allows everybody to deduct their mortgage interest against their personal income. It's the single largest subsidy Congress grants every year to everybody in the country. It's got to be the most regressive subsidy that Congress provides and I've given up trying to figure out why that is, so I just keep going and doing deals like the Brewery just to try to get it done. Let you guys do what you do up here and we'll do what we're doing locally. That's all we can do.

But I just think there's such an inconsistency in what it is that we are legislating where we're talking about management and the longevity of these complexes, we restrict the low income tax credit program after we've all been suffering—you probably more than even us—with the complaints and all the problems of low income housing that I've seen in Dade County and many of the other communities in Florida, which is no different than any of the other large cities in the country, and we all understand that it's better to mix incomes and yet public policy continually targets lower income because nobody wants to give benefits to higher income people. In the end, we're just going to undermine these communities all over again.

Senator MACK. I could go on, but I'll give you a chance and then I'll come in later.

Senator GRAHAM. Thank you.

Of that $65,000 a unit development cost, how much of that was paid through the aggregate of all of the Federal Government, either direct or through the tax code subsidies?

Mr. BARON. Well, I'm not sure that I understand. I mean there was a first mortgage, a second mortgage, and the equity of the limited partners. I'm not sure I understand the thrust of the question.

Senator GRAHAM. Well, for instance, some of them are fairly easily calculable. How much was the UDAG grant and the CDBG grant? What was the value of the interest differential between what you would have paid and what you did pay because you had mortgage insurance and because it was a tax-free bond? What was the value of the historic tax credits? Anything that I left out?

Mr. BARON. No. I mean if you're asking me what would the private market have—what would this project have supported if it had been done privately without all this Federal subsidy?

Senator GRAHAM. Well, that's another thing. That's one way to come at it. I was trying to just aggregate what the dollar value of all of those forms of Federal subsidy was and how that related to the $65,000 total cost.

Were the Federal subsidies half of the total cost of the development?

Mr. BARON. Senator, in a sense, it's—the project couldn't have been done without all of it. So to say to me what was the Federal participation in all of this, it was in all of it. Without it, it couldn't have happened. If you're trying to say of the $65,000 per unit of construction costs, $50,000 you would assign to Federal subsidies and $10,000 to something else, I don't know what the something else is because in the end the tax code raised the equity, the block grant and the UDAG funds and the credit enhancement on the bonds through D4 mortgage insurance and the ability of the redevelopment authority to issue tax-exempts were all given by Congress.

So that in the end that's what it cost to do housing units.

Now part of the problem that I think people have is that nobody really understands what it really takes to build a housing unit so that when you see these kinds of numbers and you look at the layers of subsidy that it takes to really develop an affordable unit, in the aggregate it looks like a lot. And yet that's what it costs.

Senator GRAHAM. First, I want to say I'm very appreciative of your coming here today because your insight and your willingness to share so candidly on your specific project are exactly the kind of educational tools that we who are relatively newcomers to this complex business need.

I guess the comment I'm making is that I'm hearing you saying that there are a diversity of public objectives. We have a public objective of making housing available for low income families. We have an objective of using housing as an important element of neighborhood revitalization. We have other social and economic objectives.

The question is, what is the most appropriate set of public policies to try to do this? I guess a concern that I'm getting from these numbers is that maybe by putting all of these together through a particular housing rehabilitation project and then diffusing the method of financing we have scrambled and unscrambled the egg to the point that we've lost sight of what our objective is. I was just calculating, if you took $65,000 on the assumption that the Federal subsidy was 100 percent of the project, and we're paying about 8 percent on Treasury bills now, that's $5200 a year is what the interest cost of supporting that $65,000 is, which converts to $430 a month. So you could write a check for $430 a month for the same cost to the Government of financing a $65,000 unit.

Therefore, you have to ask the question, are the benefits that are beyond the housing for $430 more than we're providing under the section 8 subsidy? So we're doing something beyond providing housing for low income people. What is that something and at a conscious public understandable level, what are we and what should we be paying for that beyond housing low income people?

Mr. Costello. Senator, one thing I'd like to add to all this is certainly the cost of this or any other development, whether good deal or bad deal, the cost of that particular development to house people of low and moderate income is substantial. But I think you've got to just jump back, as Mr. Baron has asked, and look at an overall policy.

You're not going to develop any housing programs in the inner-cities that are going to house poor and moderate income people with all the problems of the big inner-cities for a low cost.

Also, when you do that, I would also ask you to monitor the cost of housing that we have in the suburbs. I mean, the interest write-off, the highways, the whole cost of providing housing outside the city is very costly, if you really want to do a real cost-benefit study. But if you're going to look at the thing, you should back up, develop an overall strategy instead of this rigamarole of four or five different sources of funds. One time Congress feels that the tax credits are too much, we're going to cut it off in 1986. Fine, because there are some abuses. The next thing we have the block grant and you're constantly caught in a whipsaw and this is the battle in the cities. This is it right down to the bone of it.

Why don't you develop a national policy, as Mr. Baron has alluded to, and just get the money through the block grants or some vehicle like that? See what a concerted effort of cost would be, but don't kid yourself as to what the cost of suburbia is as well. That cost is pretty high too if you do some accurate cost accounting.

Mr. Baron. I think that's right, and the mortgage interest rate deductions is a very good example of that in terms of the amount that's given up every year to stimulate home ownership. I mean I think that, Senator, the response I would make is that nobody has wanted to face up to the real cost of housing people in this country. Therefore, Congress has, in its infinite wisdom, created all of these programs.

Those of us who are interested in doing it have scurried around and, as the adage goes, necessity is the mother of invention. We've had to figure out ways to do this patchwork quilt financing, but nobody has wanted to know what the real cost is because confronted with it it's so staggering that nobody wants to deal with it.

So what we do is we keep avoiding confronting reality and what it's really going to take to try to improve these neighborhoods and rather than having a single funding source with an orderly kind of way of doing this and commitment and forward funding just like with weapons systems or whatever else, you've got to deal with housing in the same way. You cannot expect people to stay in this business or ever see these areas improved unless there's some kind of consistent funding that's provided. I think people have been to the hill and they've been testifying to this fact for years and years and years and nobody wants to deal with it. So nobody deals with it. And we keep calling a peach a rose and we go on. At some point maybe we're going to get to a place where there's really going to be some national consensus that we've got to provide these funds in an orderly consistent way, forward fund them for years along the way the block grant has been going, although that keeps getting cut back, and really deal with it once and for all.

All of the issues that Congress is dealing with in terms of drugs and crime and all the rest of it, it's all interconnected with neighborhood revitalization and stabilization. When you start looking at the real costs, those are all part of it, Senator. And when you start talking about $65,000 a unit and T-bill rates and all the rest of it and look at the cost of financing all of the criminal justice programs and the prisons and all the rest of the stuff that we're doing as a nation to deal with these problems in the cities and add up the aggregate costs, I could argue with you all day long, if you put more money into housing and you allowed us to go in and stabilize these neighborhoods we'll do a lot better job in terms of dealing with crime than a lot of the other stuff that's out there with all the hard ware because a lot of it is interconnected and I think we all understand that. And we're profit-driven and bottom-line motivated and all the rest of it, but the lack of continuity in public policy in this area is so pronounced and has been so destructive over the course of the last 15 years that it's a wonder that anything gets done.

Senator GRAHAM. Senator Mack.

Senator MACK. At the risk of calling a peach a rose, I'm just going to make a couple of comments because, as Senator Graham indicated, we're going to have to move on to the next panel. But a couple of thoughts really come to mind.

In your earlier comments you talked about the cost of construction in your area is as high as the Northeast or the Far West, fairly high.

Mr. BARON. Yes.

Senator MACK. But yet the income that you can receive for rental units or for housing just isn't there. So what basically we are trying to do is we're asking the taxpayers of the country to put 1 or 1,500 million programs together to see that people can live in areas that others would argue are artificially high in its cost and people shouldn't in fact be living in those areas, but because of social policy we want to see that it takes place.

It kind of reminds me of what it must be like to be a central planner in the Soviet Union in which we laugh so much about their inefficient allocation of very scarce resources. It seems to me that's exactly the kind of thing we're being asked to do. Again, I'm just calling a peach a rose.

Mr. BARON. I think there will be a lot of those people on the market if we want to——

Senator MACK. Right.

Mr. BARON. They're all going to Florida. You've got sunshine and water to sell, Senator. We're not so lucky in Missouri.

Senator MACK. I was just making a statement. I don't really have any further questions.

Senator GRAHAM. Mr. Baron and Mr. Costello, thank you very much. This has been extremely instructive. I think Senator Mack and Senator Bryan and I have had the benefit of some very excellent professors this morning and I appreciate your patience with your students.

Mr. BARON. Thank you very much.

Senator GRAHAM. Panel two will focus on Sierra Pointe in Las Vegas. Mr. Philip Abrams of Philips Development; Mr. Joseph Queenan of the J. Michael Queenan Associates; Mr. Tom Coe, vice president of Benton Mortgage; Mr. William Tanker, vice president of underwriting, Benton Mortgage; Mr. William Cottrell, executive director of the Clark County Housing Authority; and Mr. Ols, Director of Economic and Community Development Issues of the General Accounting Office.

Gentlemen, we again appreciate your participation today. Sierra Pointe is another example of a good project which has provided 160 units of low income family housing. It is a project which raises many of the issues that have been in controversy relative to the Department.

Our purpose here today is to attempt to sift out some of the similarities and differences between Sierra Pointe and the Brewery project so that we can better understand the policy implications in developing an appropriate system for delivering housing services for low and moderate income American families.

Mr. Abrams, if you would like to speak first, we will call on the members of the panel in the order that they are listed on the agenda.

STATEMENT OF PHILIP ABRAMS, PHILIPS DEVELOPMENT, ENGELWOOD, CO

Mr. ABRAMS. Mr. Chairman, Senator Mack, my name is Philip Abrams. I'm chairman of Philips Development Corp. and I'm also the general partner of Sierra Vista Housing Associates, Ltd., the developer of the Sierra Pointe apartment project.

I don't have an opening statement to make. I look forward to answering your questions.

I can briefly tell you that my background is in building, construction, and development. I went into building construction when I got out of the Navy in 1965. I had my own business from 1966 to 1981. I built and developed residential, commercial projects throughout the Northeast. I now live in Denver, CO, and I am currently managing apartment projects.

Senator **GRAHAM**. Thank you, Mr. Abrams.

Mr. Queenan.

STATEMENT OF JOSEPH M. QUEENAN, J. MICHAEL QUEENAN ASSOCIATES, INC., DENVER, CO

Mr. **QUEENAN**. I do not have a prepared statement either, Senator. I am prepared to respond to your questions.

By way of background, I served for 11½ years within the Department of Housing and Urban Development based essentially in Denver, CO as its chief underwriter and director of housing development.

I have considerable experience in development and management of multifamily rental housing properties both in the public sector for HUD and subsequently when I left HUD 6 years ago in the private sector.

In terms of the Sierra Pointe development in Clark County, NV, I participated in it both as a general partner through a corporation and also as a limited partner. I withdrew from the property as a limited partner in 1987. I have continuing financial obligations to that property, as does Mr. Abrams.

Thank you, Senator.

Senator **GRAHAM**. Thank you.

Mr. Coe.

STATEMENT OF THOMAS E. COE, BENTON MORTGAGE CO., KNOXVILLE, TN

Mr. **COE**. Mr. Chairman and Senator Mack, thank you for inviting Benton Mortgage Co. to participate on this panel. I am Tom Coe, vice president and underwriter at Benton and with me is Mr. Bill Tanker who is also a vice president and underwriter.

Our primary purpose for testifying today is to assist this committee in understanding some of the issues that have caused problems in the HUD programs.

We believe that we are in a good position to do this because after financing over $600 million under the coinsurance programs we have never filed a claim against the insurance fund.

Despite this record, we have found ourselves caught up in the associations of mismanagement of the Mod Rehab and coinsurance programs and we feel we've been the subject of what we consider to be a very unfair IG audit report on some of the projects in which Benton Mortgage Co. financed.

Apparently the major concern in HUD with the IG report is that the participants in the program frequently failed to follow HUD regulations. This is very difficult to understand. Throughout the development of a Mod Rehab project there are significant interactions between the housing authority, the lender, HUD, and the developer. They have to communicate closely during this process by necessity because they depend on each other for information, guidance and approvals. It is an open dialog that's monitored by HUD.

That is why it is so difficult to see that the Office of Inspector General found that so many participants, so many lenders, so many developers, nearly every PHA and even in some cases the HUD offices themselves were consistently noncompliant with the regulations. It's incredible that both HUD and the parties that worked closely with HUD on a day-by-day basis could all be wrong and that the inspector general's office interpretation deemed correct.

Benton Mortgage Co. in good faith attempted to follow every rule and regulation associated with the various coinsurance programs. Not only the letter of these laws but the spirit as well. We have contributed more than $8 million to the FHA general insurance fund and have never filed a coinsurance claim against that fund. All of our coinsured projects, including the one to be discussed today, Sierra Point, meet HUD's housing quality standards. Many conventionally financed Mod Rehab projects do not meet these standards.

Nearly two-thirds of the projects that we financed house needy low income families. No other coinsurer can say that.

Despite our problem with what we consider to be an often inaccurate IG report, our company remains philosophically committed to providing decent low income housing.

As you know, the need continues to escalate and the supply continues to dwindle.

Last week Bill Tanker and I had an opportunity to sit down and talk with this committee staff. We answered questions and shared ideas. Ironically, when HUD began to have concerns over these two programs they never wanted to sit down with anyone at Benton Mortgage and talk.

At any rate, we believe the final determination of how this program worked is the number of people who received decent, safe, sanitary, and affordable housing. These units are built, they are occupied, and there are no coinsurance claims. Therefore, we invite all of you to come to one or all of the projects that we financed, talk to the tenants, inspect the units and walk through the grounds. We know you will feel that HUD's mission and Benton's goal has been achieved.

It is our company's hope that you and your colleagues can help those who could become the ultimate victims—those thousands of low income tenants who are residing in decent coinsured projects like Sierra Pointe. Our hope is that, with your help, they will not each become a nameless, faceless and homeless statistic.

We have some attachments that we are submitting for the record and we would like to stress that we are available on an ongoing basis for this or any other committee to talk about Mod Rehab or coinsurance programs or any other thing you would like to discuss.

Senator **GRAHAM**. Thank you very much, Mr. Coe.

Mr. Tanker.

STATEMENT OF WILLIAM H. TANKER, BENTON MORTGAGE CO., KNOXVILLE, TN

Mr. TANKER. Thank you. First I'd like to express my thanks and appreciation for inviting us here today to have this opportunity to speak with you.

I need to point out that neither Tom nor I were the actual underwriters for this case that we are looking at today, Sierra Pointe. We are underwriters and we have underwritten many similar cases. However, unfortunately, the actual underwriter, Mr. Bob Talbott, who came to Benton after over 30 years at HUD, is suffering from cancer and is at home and not able to come up here today. However, he will be available if we have questions or you need further information to submit written information to this panel.

Thank you.

[The complete prepared statements of Thomas E. Coe and William H. Tanker follow:]

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STATEMENT OF

THOMAS E. COE

and

WILLIAM H. TANKER

on behalf of

BENTON MORTGAGE COMPANY

before the

SPECIAL HUD INVESTIGATION SUBCOMMITTEE

of the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

February 27, 1990

Mr. Chairman and members of the Subcommittee, thank you for inviting Benton Mortgage Company to participate on this panel. I am Tom Coe, Vice President and Underwriter for Benton. With me is Mr. Bill Tanker, also a Vice President and Underwriter.

Our primary purpose for testifying today is to assist this Committee in understanding some of the issues that have caused problems in the HUD coinsurance program. We believe that we are in a good position to do this because throughout our participation in the program we have never filed a coinsurance claim with HUD. Despite this record we have found ourselves caught up in the accusations of mismanagement in the program and have been the subject of what we consider to be an unfair IG report on some projects in which Benton Mortgage was involved.

It appears that the major concern in HUD and with the IG report is that the participants in the program frequently failed to follow HUD regulations. This is difficult to understand.

Throughout the development of a Mod Rehab project such as Sierra Pointe* there are significant interactions between the coinsuring lender, the developer, the PHA, and HUD. Therefore all parties (by necessity) communicate closely during the process. They depend upon each other for information, guidance, and approvals. It is an open process monitored by HUD. That is why it is so difficult to see that the Office of Inspector General found every

HUD office, every PHA, every lender, and every developer to be consistently non-compliant with the Mod Rehab Regulations. We feel that the IG's report is unique because people who worked at HUD, and the people who worked closely with HUD on a day-to-day basis were all found to be wrong, and only the IG's interpretation deemed correct. Benton Mortgage Company in good faith attempted to follow every rule and regulation which applied to the coinsurance program (not only to the letter of the various laws, but the spirit as well).

- We have contributed more than $8 million to the FHA General Insurance Fund.
- We have never filed a coinsurance claim.
- All of our coinsured projects, including the one to be discussed today, Sierra Pointe, meet HUD's Housing Quality Standards. (Many Mod Rehabs that were conventionally financed do not meet Housing Quality Standards.)
- Nearly two-thirds of our projects house needy low income families. No other coinsurer can say that.

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*Sierra Pointe was one of the first projects Benton coinsured. We've attached a copy of the audit response for Sierra Pointe which we submitted to HUD. (It is perhaps one of the least read responses ever written.) In depositions which BMC attorneys took from the members of HUD's Mortgagee Review Board, C. Austin Fitts, James Kalish and Claire Freeman, it was revealed that the members had not read any of our audit responses.

Despite our problem with what we consider to be an inaccurate IG Report, our company remains philosophically committed to helping provide low income housing. As you know, the need continues to escalate. The supply continues to dwindle.

Last week, Mr. Tanker and I had an opportunity to sit down and talk to the staff of this committee. We answered questions and shared ideas. Ironically, when HUD began to have concerns over the program no one from the agency would sit down and have a similar conversation. At any rate, we believe the final determination on how effectively the program worked should be the number of people who received decent, safe, sanitary, and affordable housing. These units were built, they are occupied and there were no coinsurance claims. Therefore, we invite all of you to come to one or all of the projects we financed and see for yourself. Talk to the tenants, inspect the units, and walk through the grounds. We know you will agree that HUD's mission and Benton's goal have been achieved.

If this committee can sort out misrepresentations from the facts and separate the participants in the program that were effective from those that were ineffective and cost the government money, you will have advanced the process for obtaining more low income housing in our nation.

It is our company's hope that the distinguished members of this committee will help those who could become the ultimate victims - those thousands of low income tenants - who are residing in decent coinsured projects like Sierra Pointe. Our hope is that with your help they will not each become a nameless, faceless, homeless statistic because of severe reductions in HUD low-income housing assistance.

ATTACHMENTS SUBMITTED FOR THE HEARING RECORD

1) Benton Mortgage Company's Audit Response for the Sierra Pointe project
2) Outline of the process involved to start and complete a coinsured project
3) Rent approval letter from HUD
4) HUD letter instructing PHA to use Appendix 33 to determine rents
5) Brief history of Benton Mortgage Company
6) Graph "Housing The Homeless"
7) Affidavit of Robert Talbott, Chief Underwriter for the Sierra Pointe project

Attachment No. 1

SIERRA POINTE
(FHA Project No. 125-36605)

Sierra Pointe Apartments is a 160-unit multifamily rental housing project (the "Project"), constructed in 1963 and located in Clark County, Nevada. It consists of twenty two-floor walk-up buildings and contains one efficiency unit, 80 two-bedroom units with one bath, 19 two-bedroom units with two baths, and 60 three-bedroom units. The Project is owned by Sierra Vista Housing Associates, Ltd. (the "Partnership"), with Mr. Philip Abrams, former HUD Undersecretary, and Mr. Philip Winn, former Federal Housing Commissioner, as principal owners of the Project.

The Project has obtained a loan from Benton Mortgage Company ("BMC"), coinsured under the 221(d)(4) program. Initial endorsement of the Project loan occurred on December 9, 1986. In addition, a Section 8 Moderate Rehabilitation Housing Assistance Payments ("HAP") Contract was executed by the Clark County Housing Authority (the "PHA"), with respect to the entire Project, on December 8, 1986. The PHA, during the period in question, had a waiting list for assisted housing of approximately 780 families; the waiting list in Las Vegas exceeded 7,000 families, according to the HUD Regional Economist's report (Exhibit A).

The OIG Audit claims that the following findings pertain to the Project: Finding One (as to rents and appraisals), Finding Two (relating to costs), and Finding Six (as to architectural and cost reviews). BMC's refutation of Findings One, Two and Six are set forth below.

Finding One: The rents for the Project were approved by the San Francisco HUD Regional Office, as evidenced by correspondence to the PHA, dated July 23, 1987 (Exhibit B). The Firm Commitment for the Project loan, as issued by BMC (Exhibit C), was explicitly conditioned upon obtaining approval by the PHA and HUD of the HAP Agreement. This condition was satisfied through the PHA's execution of such agreement on December 8, 1986, and HUD's authorization to execute the HAP Contract.

On November 26, 1986, BMC issued a Firm Commitment to the Partnership for a coinsured loan in the amount of $7,419,700 at an annual interest rate of 9.75%. The Firm Commitment projected monthly rents for the units at $419 for efficiencies, $596 for the two-bedroom units, and $746 for the three-bedroom units. Each of the rent figures are in compliance with applicable Section 8 Fair-Market Rent ("FMR") limits.

The OIG criticism of the manner by which BMC established rents for the Project is flawed in several significant areas.

First, the OIG has stated that BMC's review appraiser increased the contract appraiser's rents and failed to properly adjust the comparables it utilized. Yet, a review of the Estimates of Market Rent by Comparison (HUD-92273) prepared by the contract appraiser (Exhibit D) and review appraiser (Exhibit E), respectively, shows that with respect to the two properties which both parties analyzed, the review appraiser adjusted rents downward on the comparable properties to a much greater degree than did the contract appraiser. For example, with respect to Las Palmas' two-bedroom, two-bath units, the contract appraiser's negative adjustment totaled $98, producing an indicated rent of $521; the review appraiser's adjustment equalled $145, resulting in an indicated rent of only $474. For that project's three-bedroom, two-bath units, the contract appraiser adjusted rents by a total of $143, which resulted in an indicated rent of $637, while the review appraiser's adjustment was $165 and the indicated rent was again lower, $615. The same result took place with respect to Alpine Village:

Two Bedroom/Two Bath Units

	Monthly Rent	Adjustments	Indicated Rent
Contract Appraiser	$435	$ -15	$420
Review Appraiser	$435	$ -85	$350

Three Bedroom/Two Bath Units

	Monthly Rent	Adjustments	Indicated Rent
Contract Appraiser	$505	$ -25	$480
Review Appraiser	$505	$ -55	$450

If, as the OIG alleges, BMC manipulated its market analysis solely to produce figures at or near the FMR levels, it would make absolutely no sense for the review appraiser to decrease indicated rents from those utilized by the contract appraiser. Indeed, the review appraiser's comparability analysis was stricter and more demanding than that utilized by the contract appraiser. If the review appraiser had simply accepted the contract appraiser's adjustments, the Correlated Subject Rents would have been almost equal to the median of the indicated rents of the comparable properties. Thus, the attempt by BMC to portray comparables honestly has been used against it. Without its action, the OIG would have had little reason to question its selection of the correlated rents from the high end of the range of indicated rents.

The fact that BMC utilized the high end of the indicated rents was not only justified, it was required by the wording of HUD Form 92273: "If prevailing vacancy rates are lower than 5%, indicating a tight rental market, the correlated subject rent should be derived from the high end of the range of the indicated rents from Line 19." The vacancy rate in the zip code area in which the Project is located was 3.4% in the fourth quarter of 1986 and has continuously been less than 5% since that time, according to data published in the "Las Vegas Housing Conditions", by the University of Nevada, Las Vegas ("UNLV")-Center for Business and Economic Research. The vacancy rate in the zip code is currently 3.3%. These figures clearly justify the use of the high end of the range.

The fact that there is a very strong demand for assisted housing should also have considerable bearing. The vacancy factor for subsidized housing in the Las Vegas area was essentially zero at the time of the underwriting. The PHA reported a waiting list of 780 eligible households, including 150 applicants who had recently responded in three days to the PHA's reopening of its waiting list. As previously stated, the total need exceeds 7,000 households when one also considers the Housing Authority of the City of Las Vegas' waiting list.

Second, the OIG has criticized the fact that the review appraiser did not, unlike the contract appraiser, adjust for condition and appeal of the newer properties it utilized as comparables. However, the review appraiser's theory on this matter is quite sound. He was comparing Sierra Pointe as a rehabilitated property to properties which were in a condition similar to that which Sierra Pointe would be after rehabilitation. The purpose of the mortgage loan was to produce a rehabilitated property. In that condition, there was no reason to make wholesale adjustments against other properties which would be in basically the same condition as Sierra Pointe when the rehabilitation was completed. Even so, the review appraiser's negative adjustments range from 11% to 23% of the quoted rents at the comparable properties.

Third, the OIG has alleged that BMC utilized an excessive trend adjustment, four percent, instead of 2.5 percent, as recommended by the Las Vegas HUD Field Office. The facts do not bear out the OIG allegation. UNLV, which conducted a very specific survey of vacancy rates in the Las Vegas area described above, found that average rents in that zip code area increased by 7.04 percent from the third quarter of 1986 to the first quarter of 1988, which covers the period in question. That increase annualizes to 4.69%, exceeding the trend adjustment utilized by BMC in calculating the rents. In addition, available data from the same source shows that from the first quarter of 1985 to the first quarter of 1986, which would have been the most up-to-date information available at the time the underwriting was conducted, rents in that area of Las Vegas increased by 4.3 percent, a figure greater than that used by BMC.

The OIG contention that BMC inflated the as-is value of the Project is based primarily on the allegation that sales prices on two comparable properties were "significantly overstated." The OIG statement is not supported by the facts.

The OIG wrongly states that the purchase price for the La Villita project was $1,482,500. In fact, records on file in the Clark County Recorder's Office show that La Villita was sold for $3,240,000, precisely the sales price utilized by BMC (see Book No. 2152, Document No. 211538, Clark County Recorder's Office).

The OIG also states that the purchase price for Marion Manor (also known as Charleston Glen) was $3,829,500. This is wrong. The purchase price for Marion Manor was $4,777,323.50, as confirmed in a telephone conversation with owner's counsel.

As BMC made clear to the OIG, it received the comparable sales data from representatives of Coldwell Banker Real Estate in Las Vegas, a well known and reputable firm. BMC had a right to rely on this data and should not have been expected to question its validity, particularly when it was produced by persons who had acknowledged expertise in this field. Even if the information turned out to be inaccurate, the OIG had no right to impugn the motives and integrity of BMC for a problem for which they were not at fault.

Finally, the OIG has criticized BMC's adjustment to the as-is sales value by reason of the existence of the Section 8 assistance at Sierra Pointe. In issuing this criticism, the OIG stated that HUD had "previously advised" BMC that such adjustments are improper. Such advice was conveyed to BMC on June 13, 1988, more than eighteen months after the Firm Commitment was issued in this matter. Although BMC has since complied with HUD's directive in valuing comparable properties, at the time of the Sierra Pointe underwriting, it believed it was fully justified in utilizing this adjustment factor and, contrary to the OIG's contention, it had never been previously advised of any impropriety in this regard by HUD. Once again, the Inspector General has created a misleading impression that BMC had willfully disregarded a directive from HUD. This charge is inaccurate and BMC rejects and resents the accusation.

In summary, the calculation of rents and as-is value were fully justified, BMC has not underwritten an excessive mortgage nor produced an inflated subsidy cost.

Finding Two: The Sierra Pointe situation is similar to Sierra Vista except that the contractor, Patti Ann Building Associates, took over construction after the original contractor, Sierra

Building Associates, defaulted. The mortgagor and Sierra Building Associates had an identity-of-interest which justified BSPRA. After the default, the mortgagor and the new contractor also had an identity-of-interest in that the mortgagor owned a limited partnership interest in the general contractor. The subcontractor involved, B.R. Scott Limited Partnership (who also served as the general contractor for Baltimore Gardens and Cleveland Gardens) was a fully capable, experienced contractor, with suitable third party relationships, who directly performed the vast majority of services set forth in its subcontracts. Once again, BMC files indicate that it analyzed the factors necessary to approve this identity-of-interest subcontracts (Exhibit F).

Finding Six: Upon examination, it is clear that the ten Change Orders cited by the OIG were necessary items. As such, this work could have been included in the original scope of work and neither the cost nor the activity would have been questioned. However, either in the interest of cost conservation or due to an inability to determine the specific condition of items or foresee the depth of rehabilitation that would be required, this work was not included in the original scope of work. Instead, the activity was added as the need for such work became apparent.

The difficulty of accurately defining the scope of rehabilitation that will be needed is even greater when faced with performing rehabilitation in an occupied building. Difficulties in initially inspecting occupied units increase the likelihood of unanticipated or latent conditions. In addition, tenant damage subsequent to the initial inspection invariably expands the items requiring repair or replacement.

For example, the work write-up identifies various shower bases which require work. However, in the case of 31 shower areas, it was determined that, in order to properly remedy the damage, it was necessary to replace the entire base since the material had rotted and would not provide appropriate surface for new tile. The kitchen counters and stair treads were installed and resurfaced as a specific requirement of the PHA, which would not approve the units for Section 8 assistance without such work. In many instances, this reflects tenant damage, which occurred subsequent to the work write-up. The need for additional patching of the stucco exteriors resulted from damage which occurred when, following the work write-up, and upon commencement of repairs, it was determined that surfaces appearing to be sound were in fact rotted and were neither acceptable nor capable of providing a sound basis for the immediately adjacent area being patched.

BMC maintains that the foregoing changes should be and were allowed since there is economic justification for them and such changes resulted in improved dwelling units for Mod Rehab tenants. Such items add value to the Project and reduce subsequent maintenance costs at the Project.

ATTACHMENT # 2

How and Where a Coinsuring Lender Fits Into the Process of a Section 8 Moderate Rehabilitation Assisted, Coinsured Mortgage Loan

1. PHA receives a Section 8 Moderate Rehabilitation Allocation from HUD;
2. PHA publishes a Notice of Funding Availability (NOFA);
3. Developer seeks out an apartment development within the PHA's jurisdiction which closely matches the requirements of the NOFA;
4. Developer acquires site control of a qualified project;
5. Developer comes to a coinsurer for an indication of interest in project financing;
6. Developer submits NOFA-specified application/proposal packet to PHA for review and selection;
7. If selected, developer applies to coinsuring lender for a commitment for coinsurance;
8. Lender visits site, prepares an initial feasibility study on the project prior to accepting an application so as to assure that the project and the developer meet all FHA/HUD requirements;
9. Upon successful completion of an initial feasibility study, the coinsuring lender begins coinsurance processing by initiating:
    A. An in-depth architectural and cost review of the proposed rehabilitation work, and a review and analysis of the credentials of the general contractor;
    B. An appraisal of the project to determine its after-rehab feasibility;
    C. A review of the proposed management agent's qualifications, background, capabilities, and experience in the management of low-income housing;
    D. An in-depth analysis of the proposed sponsor, covering their previous experience, their credit history, and their financial capacity.

10. Concurrent with the above-described processing of the coinsurer, HUD completes the following review process:

    A. An environmental analysis;

    B. A 2530-Previous Participation Review (to assure the acceptability of the sponsor, management agent, and general contractor);

    C. A review of the Affirmative Fair Housing Marketing Plan;

    D. An Intergovernmental Review (to assure project compliance and acceptability with and by all state and local governmental entities);

    E. A Housing Need/Market Opinion study;

    F. Provision of applicable Davis-Bacon wage rates to the coinsuring lender;

11. Also concurrent with both the HUD and coinsuring lender processing, the sponsor works with the PHA to determine the acceptability of the scope of work, and to determine the Section 8 rents as calculated by the PHA and HUD, and as evidenced by an Agreement to Enter into a Housing Assistance Payments Contracts (AHAP);

12. Upon successful completion of all HUD, PHA, and coinsuring lender review and analysis, the coinsuring lender issues a Firm Commitment to coinsure and finance the development;

13. Following the satisfactory completion of any conditions to the commitment, and depending upon market interest rates, the coinsuring lender sells GNMA mortgage-backed securities to finance the project;

14. HUD Initially Endorses the mortgage;

15. Construction begins, and the project is monitored by the PHA and the coinsuring lender;

16. Construction is completed, the mortgagor and general contractor prepare and submit cost certifications to the coinsuring lender and the mortgagor certifies its costs to the PHA;

17. The project achieves Final Endorsement by HUD;

18. The GNMA Construction Loan Certificates are exchanged for a GNMA Project Loan Certificate and the project begins its mortgage term.

Attachment No. 3

U.S. Department of Housing and Urban Development
San Francisco Regional Office, Region IX
450 Golden Gate Avenue
San Francisco, California 94102-3448

JUL 23 1987

W.F. Cottrell, Executive Director
Housing Authority of the County
  of Clark
5064 East Flamingo Road
Las Vegas, NV 89122

Dear Mr. Cottrell:

SUBJECT: Project No. NV39-K013-001
Rent Review at Agreement Stage

Our office has completed its review of the Section 8 Moderate Rehabilitation rents for the subject project submitted by the owner's mortgagee, Benton Mortgage Company.

Based on our review of the mortgagee's Form HUD-92273, Estimates of Market Rents, we have determined the rents are acceptable assuming the utility allowances as follows have been approved by the Housing Authority:

OBR	$21.00
2BR	$32.00
3BR	$40.00

You are authorized to execute a Housing Assistance Payments Contract for the rents shown in the executed HAP Agreement.

If you have any questions, please call Diane Brambila, Housing Representative, at (415) 556-4557.

Very sincerely yours,

Ron Halpern

Ronald F. Halpern
Director
Housing Development Division

RECEIVED
JUL 27 1987
[illegible]

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Attachment No. 4

U.S. Department of Housing and Urban Development
San Francisco Regional Office, Region IX
450 Golden Gate Avenue
San Francisco, California 94102-3448

29 JAN 1987

Mr. W. F. Cottrell
Executive Director
Clark County Housing Authority
5064 East Flamingo Road
Las Vegas, NV 89122

Dear Mr. Cottrell:

SUBJECT: Project No. NV39-K013-001

This is a follow-up to the recent telephone conversation you had with Diane Brambila of my staff regarding the role of the coinsurance lender in the development of the captioned Moderate Rehabilitation Project.

Since the developer elected to obtain financing from an FHA (HUD) approved 221(d) multifamily coinsurance mortgage lender, the roles which HUD would assume pursuant to Appendix 33 of the HUD Moderate Rehabilitation Handbook are assumed by the coinsurance lender.

If you have any questions, please let me know.

Sincerely,

Ronald Halpern

Ronald F. Halpern
Director
Housing Development Division

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FEB 02 1987
C. C. HOUSING [illegible]

ATTACHMENT # 5

Benton Mortgage Company
History, Philosophy, Credentials

Mr. Fred Benton and the principals of Benton Mortgage Company have been active in the field of low income housing development and finance since the late 1950's. During much of this time our financing of housing has been tightly interwoven with various HUD and FHA housing programs. Our efforts have resulted in the construction or rehabilitation of nearly 16,000 apartments, which total to more than $1.3 billion in total financing. Throughout our Company's history our primary goal and focus has been to provide safe and decent low income housing. Mr. Fred Benton's philosophy can be best summarized by a quote from Samuel Johnson: "Decent provision for the poor is the true test of civilization." All members of the firm embrace this philosophy, and we are all deeply committed to continue to find and utilize new, innovative, and prudent methods of producing and financing low income housing units.

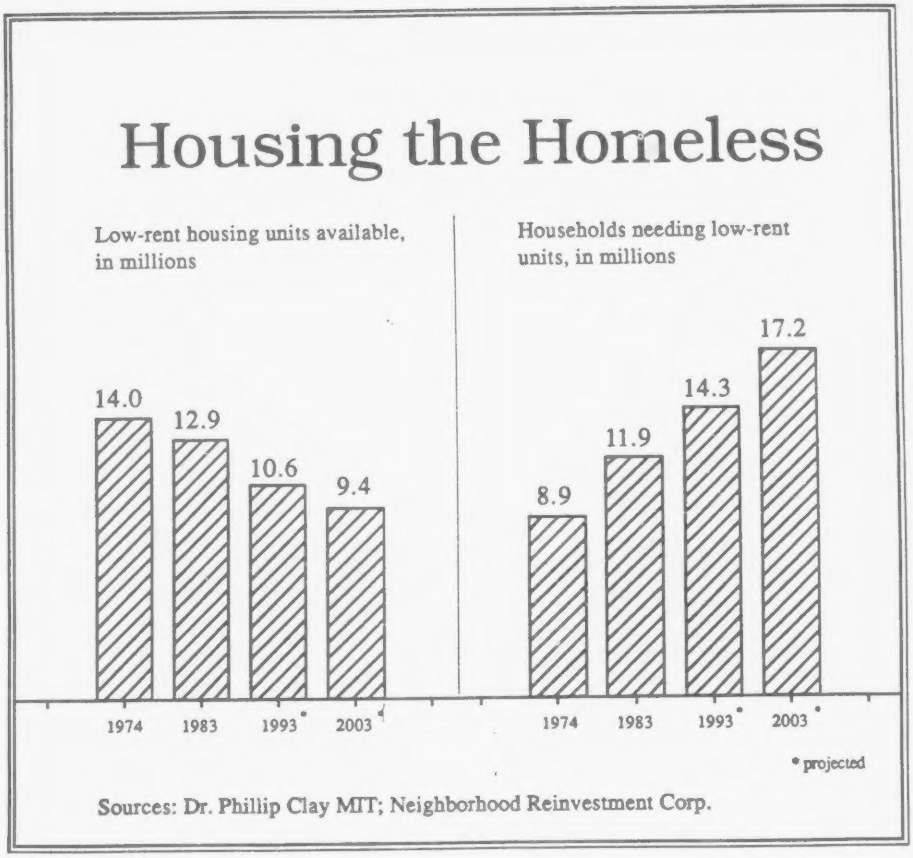
The principals of Benton Mortgage Company have been at the forefront of underwriting tax-exempt bond issues to finance Section 8 Subsidized housing projects-both with and without FHA insurance. They have underwritten over 300 tax-exempt multifamily bond issues, with 178 of the issues being used to finance Section 8 subsidized projects. As the laws governing tax-exempt bonds continued to change and reduce the size of the tax-exempt market, the principals of Benton Mortgage Company believed that the FHA coinsurance programs provided the most viable source of financing for affordable multifamily housing. Consequently, Benton Mortgage Company was formed in 1985 to act as an FHA coinsurer. Benton has 47 employees and its main office is in Knoxville, Tennessee.

Each of Benton Mortgage Company's coinsured loans has been funded through the issuance of GNMA mortgage-backed securities. In 1988, we issued the second largest amount of GNMA securities of any multifamily lender in the country, and Benton Mortgage Company has always met its obligations to the holders of these securities.

Benton enjoys a strong reputation and proven record as a mortgage lender. As such, the Federal National Mortgage Association selected Benton Mortgage Company as one of the first ten lenders approved under FNMA's Delegated Underwriting and Servicing Program. Benton Mortgage Company currently has a portfolio of 146 FHA-coinsured mortgage loans totaling $626,273,300. Benton has never made a claim against FHA's General Insurance Fund because of a default or foreclosure on any of these loans, and Benton annually contributes over $2,000,000 to that fund.

Our portfolio is sound, well diversified, and as approximately two-thirds of our portfolio represents Section 8 assisted developments, demonstrably focused on the provision of decent, safe, sanitary, and affordable housing. No other coinsuring lender has made this commitment.

Attachment No. 6



Sources: Dr. Phillip Clay MIT; Neighborhood Reinvestment Corp.

Recreated from:
Weekly Reader
Edition 5, Volume 68
Issue 14
January 26, 1990

Attachment No. 7

Date: ____________________

Affidavit of Robert Talbott.

I am currently employed by Benton Mortgage Company in the position of Senior Underwriting Advisor. My employment with this firm commenced on October 1, 1979. Prior to acquiring my current title on March 30, 1988, I served Benton Mortgage Company as Chief Underwriter.

My experience in HUD processing was initially developed during my employment by the Department, from March 1946 to August 1979. During this period of time, I served in the following capacities:

	Position	Location	Dates
1.	Deputy Director for Development	Knoxville, Tennessee	06- 1978 / 08-1979
2.	Director, Operations	Knoxville, Tennessee	04-1975 / 06-1978
3.	Chief Underwriter	Knoxville, Tennessee	10-1971 / 04-1975
4.	Deputy Chief Underwriter	Knoxville, Tennessee	1969 / 1971
5.	Deputy Chief Architect	Knoxville, Tennessee	1962 / 1969

I hereby affirm that I employ the same underwriting standards as a Benton Mortgage Company employee as I did as a HUD official and that all my underwriting activities and the underwriting activities of Benton Mortgage Company during the period covered by the HUD monitoring review of October 1987 and by HUD Audit # 89-TS-221-1001 met acceptable HUD criteria.

Further, the Affiant saith not.

/s/ Robert Talbott

Robert Talbott
Senior Underwriting Advisor

Senator GRAHAM. William Cottrell.

STATEMENT OF WILLIAM F. COTTRELL, EXECUTIVE DIRECTOR, HOUSING AUTHORITY OF THE COUNTY OF CLARK, LAS VEGAS, NV

Mr. COTTRELL. Mr. Chairman, I'm executive director of the housing authority of the county of Clark. Our authority serves approximately 2,750 low income families. We currently have about 2,400 people, families and senior households on our waiting list.

Our agency, in conjunction with the owner and developer, Sierra Vista Housing Associates, produced the Mod Rehab project known as Sierra Pointe, which consists of 160 two and three bedroom apartments. Prior to this time our authority had not participated in the Mod Rehab Program.

In late 1985 we were made aware through a HUD regional office bulletin of an allocation of 8,000 units to be distributed on a nationwide basis.

Some time in the early spring of 1986, we were contacted by Mr. Phil Abrams, representing the Winn group, and Mr. Abrams indicated he was interested in the Mod Rehab Program in our area of jurisdiction.

In April, Mr. Abrams and his associate, Mr. J. Michael Queenan, furnished at our request copies of administrative plans, forms and other materials used by other local agencies who had participated in the program. We used some of this material in preparing our own plan, procedures and forms.

At the same time, Mr. Abrams outlined specific properties in our area which were suitable for the Mod Rehab Program. Our staff read and analyzed the HUD program requirements which I must point out are scattered throughout the HUD section 8 existing housing handbook, there being no specific handbook on Mod Rehab.

On April 18, 1986, we wrote a letter of interest to Mr. Silvio De Bartolomeis, who at that time was the General Deputy Assistant Secretary for Housing, and we requested funding for 200 units of section 8 Mod Rehab which was an amount that we thought we could reasonably process.

We then advertised for proposals in accordance with the HUD program requirements, and we advertised at this time even though we had not yet had an indication that we would be funded, in view of the short period of time that was available to complete all the HUD process—advertising, preparation of proposals by developers, authority review and evaluation of those proposals, completion of the funding application to HUD, and the HUD processing which it was our understanding would have to be completed by the end of the fiscal year which was September 30, 1986.

We advertised for proposals in the largest newspaper in the area, the Las Vegas Review Journal, on April 30, May 7 and May 14, and had a deadline for submittal of proposals of May 20. In addition to Mr. Abrams, we were contacted by two other developers, one from Visalia, CA and one from Salt Lake City. However, at the time the deadline for receival of proposals we had received only one and that was from Mr. Abrams and his group.

Later in May, we received a phone call from our then Senator from Nevada, Chic Hecht, who informed us that we were to be funded for the program. At about the same time we had a phone call from the HUD regional office in San Francisco giving us the same information.

On May 23, we then wrote to the regional office requesting information on the required application and on June 2 we received a letter from the regional administrator inviting us to submit a proposal for a Mod Rehab Program of 160 units of housing with a maximum section 8 annual contract authority of $1,320,000. On the same day, we received a letter from Susan Zagame of the HUD central office notifying us of the approval with the added information that the total budget authority for this project would be $19,807,000.

Our application then was submitted to the HUD regional office in San Francisco on June 12, 1986.

The proposal received from Philip Abrams and Associates was submitted to our board at its meeting of May 21 but inasmuch as we had no funding at that point, no action was taken and the proposal was accepted as received.

On July 7, we received from the regional office a copy of the central office directive dated May 16, 1986 on the subject of PHA administration of the Mob Rehab Program. We carefully reviewed that directive and came to the conclusion that we had met all of the program requirements except for completion of the required administrative plan which we were then in the process of drafting.

At our meeting of the board of commissioners of our authority on July 16 action was taken to approve the Sierra Pointe proposal from Mr. Abrams. No further formal action was taken then until September 29, at which time HUD approved the application.

On October 16, we received from the regional office an amendment to our annual contribution contract and the administrative plan was conditionally approved by HUD in September and the final revised draft was accepted by HUD in November 1986.

At some time after receiving the Abrams proposal we became aware that he was proposing to use the HUD coinsurance program through Benton Mortgage Co. We had no particular interest in nor concern with his source of funding inasmuch as the authority would be involved with funding only after the fact through the section 8 certificate payments.

Mr. Abrams' statements to the authority in a letter dated January 5, 1987 concerning the responsibility of the coinsurer for performing certain aspects of the program such as rent determination were questioned by the authority. We wrote to the HUD regional office in San Francisco for clarification of the roles of the developer, the coinsurer, and the authority. Unfortunately, the regional office was unable to answer our questions and answers from Washington were not received in time to affect Sierra Pointe rent determinations.

Rents were determined by the coinsurer, Benton Mortgage. We forwarded the rents calculated by Benton to the regional office of HUD in San Francisco. They asked for the calculations used by Benton which we obtained from Benton and forwarded to San

Francisco. HUD then approved the rents submitted by Benton. The housing authority was not involved in that determination.

The HUD inspector general in his report released in 1989 said that we did not follow provisions in the administrative plan in selecting this proposal. We pointed out that the ranking and rating provisions of the plan were moot in this case inasmuch as there was only one proposal to consider. We further noted that the proposal was fully responsive to HUD and local requirements and therefore there was no good reason to reject it only because it was the single proposal received.

I want to talk a little bit about Sierra Pointe itself. Sierra Pointe today is fully occupied except for normal turnover of residents and is a successful development providing safe, affordable housing to very low and low income families. At the present time we have 151 of those 160 units occupied. 144 of those families are single parents. Virtually all of those families receive some form of public assistance, including 97 who receive AFDC payments. The average family income is $5,790 per year. The average gross monthly family contribution is $63, but after you take off the utility allowance for which they are allowed for utilities that they pay for, the net monthly cash rent paid by the family is $11.85 per month on average. So you can see that this development is housing families of very low income, families who had been on our waiting list and could not afford decent apartments in the private market without Federal assistance.

Currently the waiting list for Sierra Pointe is 180 families. In addition, we have 1200 families on our waiting list for section 8 certificates and vouchers who could be referred to Sierra Pointe as well. The average wait for those on those waiting lists is from 6 weeks to 24 months.

Actions related to this program must be viewed in the context of the time period in question. HUD funds for housing construction and acquisition had been greatly reduced during the 1980's. By 1989, these cuts reached 70 percent. Housing authorities were reduced to fighting over the scraps and bones that were available. We were interested in any HUD program which could provide additional resources.

For the Mod Rehab Program the allocation for 1986 was 8,000 units nationwide for 3,300 housing authorities. Because its funding level was so low, Congress in the appropriations bill waived the statutory fair share requirement. As a result, allocation of Mod Rehab money was left to the discretion of the HUD Secretary and the central office staff.

In reviewing and analyzing our participation in the program retrospectively, authority staff has reached the following conclusions as to some of the problem areas.

There were basic problems relating to rent determination, by whom, under what criteria, and when, and other pertinent aspects of the program arose as a result of different requirements between the HUD mortgage insurance program and the section 8 existing housing program. These problems were never resolved during the development of Sierra Pointe.

Although HUD has since clarified the question of determination of rents, other questions remain unanswered and there is still no handbook on the program.

HUD failed to provide the housing authority with the mandatory preapplication conference or the basic information and regulations of the Mod Rehab Program. Our attempts to gain information from the regional office were basically unsuccessful. In fairness to that staff, it must be noted that they were as frustrated as we in their attempts to obtain programmatic and regulatory clarifications from the HUD central office.

HUD was unable to provide field and technical assistance to the authority. We had one field visit during the Mod Rehab period and one followup visit approximately 6 months after.

Mr. Chairman and Senator Mack, there are many other aspects of this process and I will be happy to discuss those or to answer any questions.

[The complete prepared statement of W.F. Cottrell follows:]

STATEMENT OF W. F. COTTRELL Executive Director Housing Authority of the County of Clark Las Vegas, Nevada	SIERRA POINTE APARTMENTS Section 8 Moderate Rehabilitation Project (Clark County, Nevada)

before the
SENATE HUD/MOD REHABILITATION INVESTIGATION SUBCOMMITTEE

Washington, D.C.
February 27, 1990

My name is William F. (Bill) Cottrell, and I am the Executive Director of the Housing Authority of the County of Clark, Nevada. Our Authority owns and manages 750 units of conventional low-rent public housing, contracts for 1,350 Section 8 certificates and vouchers, administers Housing Assistance Payments Contract for 160 units of Section 8 new construction and Section 202 elderly housing, and owns and manages 231 units of non-Federally assisted housing. In all, we serve about 2,750 low-income families. There are currently 2,440 families and senior households on our waiting list for all housing assistance programs. The average family size in our low-rent program is 3.63 persons; average family income is $8,967.47 per year; the average monthly cash rent paid is $138.46; and the average cost of managing, operating, and maintaining a family dwelling is $240.89 per month.

Our agency, in conjunction with the owner/developer (Sierra Vista Housing Associates, Ltd.), produced the mod rehab project known as Sierra Pointe Apartments (consisting of 160 two- and three-bedroom apartments in Clark County) during 1986-1987. Prior to this time, our Authority had not participated in the Mod Rehab program.

In late 1985 we were made aware (through a HUD Regional Office Bulletin) of an allocation of 8,000 units to be distributed on a nationwide basis. Sometime in the early spring of 1986 (probably March), we were contacted by Mr. Phil Abrams, representing the Winn Group, referred to us by the Housing Authority of the City of Las Vegas. Mr. Abrams indicated he was interested in the mod rehab program in our area of jurisdiction and mentioned several properties which he felt would be suitable.

In April, Mr. Abrams and his associate, Mr. J. Michael Queenan, furnished (at our request) copies of administrative plans, forms and other materials used by other local agencies participating in the program. We used some of this material in preparing our own plan, procedures and forms. At the same time, he outlined specific properties in our area which were suitable for the mod rehab program. Staff read and analyzed the HUD program requirements (scattered throughout the HUD Section 8 Existing Housing Handbook), and attempted to obtain information from the HUD Regional Office in San Francisco. (There is no mod rehab handbook; it is necessary to glean specific provisions for the program from the regular Section 8 handbook. There is no reference in the Section 8 handbook to the HUD coinsurance program, or how the two interface).

On April 18, 1986, we wrote a letter of interest to Mr. Silvio de Bartolomeis, General Deputy Assistant Secretary for Housing, requesting funding for 200 units of Section 8 mod rehab, this number being what we felt we could reasonably process. In addition to the letter of interest to HUD, we notified our congressional delegation of our interest in the program through letters written to (then) Senators Paul Laxalt and Chic Hecht and (then) Congressman Harry Reid dated April 25, 1986.

We then advertised for proposals in accordance with program requirements (even though we had not yet had an indication of funding) in view of the short period of time available to complete the HUD process (advertising, developer preparation of proposals, Authority review and evaluation, completion of the funding application, and HUD processing) prior to the end of the Federal fiscal year on September 30, 1986. Advertisements were placed in the largest area newspaper (The Las Vegas Review-Journal) on April 30, May 7 and May 14, with a deadline for proposals of May 20, prior to our Board meeting on May 21. We were contacted by two other developers (one from Visalia, California and one from Salt Lake City, Utah) in response to these ads. When the deadline was reached, we had received only one proposal, that being from the Abrams group, located in Colorado, for the (then) Patti Ann Apartments (now Sierra Pointe) consisting of 160 units.

In the meantime, we had received a letter dated May 2 from Susan K. Zagame, Deputy Assistant Secretary for Policy, Financial Management and Administration, HUD-Washington, informing us that a substantial amount of the 1986 funding was to be deferred to FY 1987, and that no funding would be forthcoming until the impact of that deferral could be determined.

On May 12, 1986 we wrote to Ms. Zagame with information we had received from an industry newsletter to the effect that 8,000 mod rehab units were to be released by the Office of Management and Budget on or about May 15, and reiterating our desire for funding for 200 units.

Later in May (date unknown) we received a phone call from Senator Hecht's Washington office as well as his Las Vegas office informing us that we were to be funded for the program. At about the same time we had a phone call from the Regional office of HUD in San Francisco, giving the same information. On May 23 we wrote to the Regional Office requesting information on the required application, and on June 2 we received a letter from the Regional Administrator inviting submittal of an application for a mod rehab program of 160 units of housing with a maximum Section 8 annual contract authority of $1,320,480. On the same day we received a letter from Susan Zagame from HUD Central notifying us of the approval, with the added information that total budget authority was $19,807,200. Our application was submitted to the HUD Regional Office in San Francisco on June 12, 1986.

The proposal received from Philip Abrams and Associates was submitted to our Board at its meeting of May 21, 1986. Inasmuch as we had no funding at that point, no action was taken, the proposal being accepted as received. On July 7 we received from the Regional Office a copy of a Central office directive dated May 16, 1986 on the subject of PHA administration of the mod rehab program. We carefully reviewed that directive and came to the conclusion we had met all of the program requirements, except for completion of the required administrative plan, which we were then drafting.

At the meeting of the Board of Commissioners on July 16, 1986 action was taken by adoption of a Resolution to approve the Sierra Pointe proposal from Mr. Abrams. No further formal action was taken until September 29, 1986 at which time HUD approved the application. On October 16, 1986, we received from the Regional Office the amendment to the Annual Contributions Contract for this project. The administrative plan was conditionally approved by HUD in September, and the final revised draft was accepted by HUD in November, 1986.

At some time after receiving the Abrams proposal, we became aware that he was proposing to use the HUD coinsurance program (through Benton Mortgage Company) to fund this development. We had no particular interest in nor concern with his source of funding, inasmuch as the Authority would be involved with funding only after the fact, through the Section 8 certificate payments.

Mr. Abrams' statements in a letter dated January 5, 1987, concerning the responsibility of the coinsurer for performing certain aspects of the program such as rent determination were questioned by the Authority. We wrote to the HUD Regional Office in San Francisco for clarification of the roles of the developer, the coinsurer, and the Authority. Unfortunately the Regional Office was unable to answer our questions, and answers from Washington were not received in time to affect Sierra Pointe rent determination.

Rents were determined by the coinsurer, Benton Mortgage. As we saw it, and assuming the assertions made by the developer were correct, we had no real role in rent determination. We forwarded the rents calculated by Benton Mortgage Company to HUD. The HUD Regional Office asked for the calculations used by Benton, which we obtained and forwarded to San Francisco. HUD then approved the rents submitted by Benton.

At no time during this process were any promises made or assurances given by any party. The Authority operated above board and in full compliance with what we believed to be the HUD requirements (although subsequently we received further information from HUD in the areas of the administrative and relocation plans).

The HUD Inspector General in his report released in 1989 said that we did not follow provisions of the administrative plan in selecting this proposal. We pointed out that the ranking/rating provision of the plan was moot in this case, inasmuch as there was only one proposal to consider. We further noted that the proposal was fully responsive to HUD and local requirements, and therefore there was no good reason to reject the single proposal received.

It has been suggested that we might have re-advertised. There was no good reason to do so. Firstly, there was no reason to believe that any other proposals would be received. We are in a fairly remote area, and there are no local developers with modernization experience. Secondly, the proposal received was fully responsive, was feasible, and was in compliance with HUD and Authority requirements. Thirdly, this action might have delayed the process so that it would have been impossible to meet the September 30 fiscal year deadline.

Sierra Pointe - The Result. Modernization was begun in March and completed in stages, with the final buildings occupied late in 1987. Thus the total elapsed time from advertising until completion of the rehab work for all 160 apartments was approximately 18 months. Sierra Pointe today is fully occupied (except for normal turnover of residents) and is a successful development providing safe, affordable housing to very-low and low-income families. The following statistics (as of 2/16/90) on Sierra Pointe may be of interest:

Number of Families in Occupancy 151

(NOTE: The 9 vacancies are only normal turnover).

Total family members	451
Total number of minors	278
Number of single-parent families	144

Family Income by Source (may be more than one per family).

Wage income	40
A. F. D. C. payments	97
Social Security payments	10
S. S. I. payments	30
Other benefits	11
Total	188

Average Annual Family Income. . . . . $ 5,790.74

Average gross monthly family contribution	$63.01
Less average monthly utility allowance	51.16
NET MONTHLY CASH PAYMENT BY FAMILY (AVERAGE)	$11.85

Average Monthly Housing Unit Assistance Payment to Owner. $587.88

This development is housing families of very low income who had been on our waiting list and could not afford decent apartments on the private market without federal rental assistance. Is the development a success? It certainly is. The current waiting list to get into Sierra Pointe contains at least 180 names. In addition, we have 1,200 families on the certificate and voucher waiting lists who could be referred to Sierra Pointe. The average wait for a unit for those on the waiting list is from six weeks to twenty-four months.

A point has been made by others that the vacancy rates in the Las Vegas area at the time Sierra Pointe was developed were such that eligible applicants could have been accommodated in existing housing rather than rehabilitating Sierra Pointe. The Clark County Housing Authority did not have sufficient allocations of existing certificates and vouchers necessary to accommodate those on our waiting lists. Average rents were approximately $400 to $425 per month. Units available to and affordable by very-low income families for no more than 30 percent of their income would have to rent for $65 per month. Obviously no safe, decent and sanitary units are available at that rent.

Further, the mod rehab program guarantees the availability of low income housing for a minimum of 15 years, whereas the Section 8 existing program leases units on a yearly basis.

Actions related to this program must be viewed in the context of the time period in question. HUD funds for housing construction/acquisition had been greatly reduced during the 1980's. By 1989 these cuts reached 70%. Housing Authorities attempting to serve low-income persons were reduced to fighting over the scraps and bones available. We were interested in any HUD program which could provide additional resources. For the mod rehab program, the allocation for 1986 was only 8,000 units nationwide for 3,300 Authorities! Because this funding level was so low, Congress, in the appropriations bill, waived the statutory fair share requirement. As a result, allocation of mod rehab monies was left to the discretion of the HUD Secretary and Central Office staff.

In reviewing and analyzing our participation in the program retrospectively, Authority staff have reached the following conclusions as to some of the problem areas:

Basic problems relating to rent determination (by whom, under what criteria, and when) and other pertinent aspects of the program arose as a result of different requirements between the HUD mortgage insurance program and the Section 8 existing housing program. These problems were never resolved during the development of Sierra Pointe. Although HUD has since clarified the question of determination of rents, other questions remain unanswered, and there is still no specific handbook for the program.

HUD failed to provide the Housing Authority with the mandatory preapplication conference, or the basic information and regulations for the mod rehab program. Our attempts to gain information from the Regional Office were basically unsuccessful. (In fairness to that staff, it must be noted that they were as frustrated as we in their attempts to obtain programmatic and regulatory clarifications from HUD Central).

HUD was unable to provide field and technical assistance to the Authority. We had one field visit during the rehab work period, and one follow-up visit approximately six months after completion of the rehab work.

There are many other aspects of the process and procedures involved in this program, which I will be happy to discuss if there is interest and time available to do so.

Senator GRAHAM. Thank you very much, Mr. Cottrell.

Mr. John Ols.

STATEMENT OF JOHN M. OLS, JR., DIRECTOR, HOUSING AND COMMUNITY DEVELOPMENT ISSUES, RESOURCES, COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. OLS. Mr. Chairman, this is the third time I have come before you to discuss Mod Rehab and it's my pleasure to be here again today to discuss our analysis of what's happened and what has been the impact on the community, on low income families, and whether or not we could have assisted more through other mechanisms. I think our prior witnesses talked about various programs that are trying to combine things. What we tried to do is say, if we had the same dollar amounts, what could we have done, who could we have assisted. I think as Mr. Cottrell just said, there are 180 people on the waiting list, in Clarke County. So there are families to assist in various communities, not just in Las Vegas or in Sierra Pointe but across the country.

I would like to just summarize some parts of my statement and discuss some of the things that I think are very key to what we're doing and the charts that we have tried to put together. I might add, starting off, that Benton Mortgage has provided us a lot of the data and a lot of the schedules which allowed us to bring some of these figures to the table. Without their assistance, we could not have made the analysis we had.

In some cases we may not have all the current or most current figures. If those situations come up, we are willing to incorporate that information in our analysis and then go forward and share that with you either today or later on.

In summary, we believe there is a danger of providing too much financial assistance to a developer when multiple subsidies are awarded to individual projects without a review of the total amount of assistance in the particular case. For Sierra Pointe, a 160 unit project, we estimate that the developer realized cash flows of about $1.8 million or about 22 percent above the cost to acquire and rehabilitate the project. This cash flow was generated from the proceeds of tax credits combined with loan proceeds secured by rental subsidies for 15 years provided under the Mod Rehab Program.

Aside from the issue of awarding substantial subsidies, there's also a real danger of using these subsidies inefficiently. It is inefficient to use the Mod Rehab Program and tax credits in housing markets that already have an adequate supply of existing rental housing.

At the time Sierra Pointe was approved and during its development, estimates of the vacancy rate for rental units in Clarke County ranged from 4 to 8 percent and there are a variety of estimates of what that vacancy rate is for the zip code where Sierra Pointe was located over the years 1985 to 1988. According to Federal Home Loan Bank Board out of San Francisco, the rate was around 9 percent, which means there were units available.

These estimates, given the approximately 80,000 rental units in Clarke County, suggest that there may have been upwards of several thousand vacant units. While we cannot go back in time to determine the condition of these units, we believe that it is reasonable to conclude that at least 160 suitable units could have been made available to low income families.

Moreover, Mr. Cottrell had told us that when the Sierra Pointe project was approved, low income families were not experiencing any difficulty finding housing using the HUD section 8 certificate program.

Our analysis shows that if certificates had been used instead of the Mod Rehab Program and tax credits, about 419 households could have been assisted rather than the 160 households assisted in the Sierra Pointe project.

In essence, Mr. Chairman, that would be an additional 259 households that could have been assisted.

On the basis of our preliminary work on the other seven projects which we are reviewing for the subcommittee, we are finding it would have been more economical to have relied on existing rental housing using section 8 certificates rather than producing additional units through the combination of Mod Rehab and tax credits, and actually that comes out to be about 850 units in these other locations.

The developer of the Sierra Pointe project, like the developers of the other seven projects we are reviewing, used subsidies offered under the Mod Rehab Program along with the tax credits to generate substantial cash flows. The Sierra Pointe project which has been talked about already includes two and three bedroom units and was placed in service in 1987. As a matter of fact, I believe there is only one unit which is a one bedroom unit. All the rest are two and three, and two bedrooms account for two-thirds of the projects' total unit size and three bedrooms are the remaining one-third.

Our first chart, on the left, and it's also attachment one to my statement, presents our cash flow analysis. I will just gloss over that and if we want to come back to that in your detailed questions we'll be able to respond.

Basically, the principal sources of the funds were $7.4 million which was the mortgage loan and tax proceeds which were $2.3 million. Total actual tax credits amounted to $5.8 million over the 10-year period. We used an estimated sale price of roughly 45 cents on the dollar or 45 percent to come up with our calculation.

Our chart also shows that $3.7 million was used to acquire the project and another $4.5 million to rehabilitate it. In addition, we estimated the developer received a fee of about $900,000 which equates roughly to 20 percent of rehab costs, which is a figure that's determined in all States across the country and that was the rate that we used based on what Nevada officials had told us.

When these principal uses of funds are combined with other adjustments, the estimated proceeds to the developer amounted to about $1.8 million or 22 percent above the cost to acquire and rehabiliate the project. That equates to an average of $11,400 per unit.

I might add here, if you would calculate as we did, the developmental cost to rehab these 160 units you would come out with

$28,000 per unit. And if you remember the gentlemen on the first panel talked about $65,000 a unit. This is the unit cost $28,000 to rehab if you just consider developmental costs and ignore the land cost. We can come back to that as we talk further.

There are no standards or guidelines that we are aware of or that we came up with in our study on the amount of proceeds a developer can realize above the cost of acquiring and redeveloping projects. However, we believe that the Sierra Pointe developer, as well as most developers of other projects such as these, realized substantial cash flows greater than what would have been required to ensure project feasibility. You've got to remember there's no risk involved. This loan is coinsured. We have a guaranteed rental structure for a period of 15 years. I think a prior witness used a figure of 12 to 15 percent. To me, that is a reasonable rate of return to be expected. As a matter of fact, the example that he used I think his example only comes out to about 5 percent.

The inefficient use of Federal housing subsidies has serious repercussions on low income families. As shown in our second chart and in attachment two to my statement, rents at Sierra Pointe for two bedroom units were $596 per month. That is the same as the fair market rent as established by HUD for that area.

Keep in mind the developer could have exceeded that rent by 20 percent. He could have gone up to $700 and some dollars that is allowable under the Mod Rehab Program the way it was designed and the way it could have been implemented. I stress that $596 was the same as the fair market rent for a 2-bedroom unit in that area.

Section 8 certificate subsidies at this rent level, when adjusted for inflation and combined with awarded tax credits, will total about $23 million over the next 15 years. By contrast, using other prevailing market rental rates in the Clark County area for two bedroom apartments, which are $425 per month, you would subsidize rents using certificates and adjusting for inflation at roughly $9 million over the next 15 years. That's the Government share and I can give you a hypothetical situation of how you come up with that and it's based on the income of the recipients where they're paying 30 percent of their income for rent and the Government is picking up the rest of the burden on that $425, which comes out to be $275 in subsidies and $150 in tenant rent contribution.

Looking at the situation another way, our analysis shows that based on the average annual voucher/certificate subsidy of about $3,300 per household for the area, about 419 families could have been assisted for about the same amount of Federal subsidy of $23 million which was required for this particular project. This represents an increase of 162 percent or 259 additional households.

Recent changes to the Mod Rehab and tax credit programs which you are well aware of did change many of these procedures. The biggest one is the tax credit change which prohibited the use of tax credit subsidies when you're using the Mod Rehab funds. The Mod Rehab Program set a minimum rehabilitation cost at $3,000 and the maximum number of units at 100 that could be rehabilitated. In addition, the amount of rental subsidies that can be awarded to the project when tax credits are used, they're supposed to look at those two types of assistance. Many of the same things that we had talked about when we testified last August and September as problems we thought could be gotten under control.

These combinations and these legislative changes we believe will help enhance the controls over these problems. One of the questions we were asked is what can we do? I think these are some good starts. I do believe and I think as Benton Mortgage said, nobody is taking issue—and we surely are not here to take issue with the quality of the projects which were constructed. They are good projects. They did provide units. They are housing low income families, which I think we all want to do. What we looked at is whether or not we couldn't have done more with some other system to give us more assistance for more families and that's really what I would leave you with as our bottom line. Nobody is arguing with the quality of these projects.

Mr. Chairman, that concludes my statement and I will be glad to answer any questions that you or the members might have.

[The complete prepared statement of John M. Ols, Jr. follows:]

United States General Accounting Office

GAO Testimony

USE OF HOUSING SUBSIDIES

For Release
on Delivery
Expected at
9:30 a.m. EST
Tuesday
February 27, 1990

Statement of
John M. Ols, Jr., Director
Housing and Community Development Issues
Resources, Community and Economic
Development Division

Before the
Subcommittee on HUD/Moderate Rehabilitation
Investigations
Committee on Banking, Housing, and Urban Affairs
United States Senate

Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to assist the Subcommittee in analyzing HUD's Section 8 Moderate Rehabilitation Program. As you know, we testified before the Senate Committee on Banking, Housing, and Urban Affairs on August 2 and September 29, 1989, regarding our analysis of cash flows to developers of eight Moderate Rehabilitation projects and of ways to improve the efficiency of federal housing subsidies. Today, we will discuss the results of our analyses of one of these projects, Sierra Pointe, located in Clark County, Nevada. I will also discuss the financial ramifications and the associated impact on low-income families of using the Moderate Rehabilitation Program and tax credits.

In summary, there is a real danger of providing too much financial assistance to a developer when multiple subsidies are awarded to individual projects without a review of the total amount of assistance. For Sierra Pointe, a 160-unit project, we estimate that the developer realized cash flows of about $1.8 million, or about 22 percent, above the cost to acquire and rehabilitate the project. This cash flow was generated from the proceeds of tax credits combined with loan proceeds secured by rental subsidies for 15 years provided under the Moderate Rehabilitation Program.

Aside from the issue of awarding substantial subsidies, there is also the real danger of using subsidies inefficiently. It is inefficient to use the Moderate Rehabilitation Program and tax credits in housing markets that already have an adequate supply of existing rental housing. At the time Sierra Pointe was approved and during its development, estimates of the vacancy rate for rental units in Clark County ranged from 4-8 percent. These estimates, given the approximately 80,000 rental units in Clark County, suggest that there may have been upwards of several thousand vacant units. While we cannot go back in time to determine the condition of these units, we believe that it is reasonable to conclude that at least 160 suitable units would have been available to house low-income families. Moreover, the Director of the Clark County Public Housing Authority told us that when the Sierra Pointe project was approved, low-income families were not experiencing any difficulty finding housing using HUD's Section 8 certificate program. Under this program, a family pays 30 percent of its monthly adjusted income for rent, and HUD pays the private landlord the difference between the tenant's payment and an approved monthly rent. Our analysis shows that if certificates had been used instead of the Moderate Rehabilitation Program and tax credits, about 419 households could have been assisted rather than the 160 households assisted in the Sierra Pointe project. In essence, Mr. Chairman, another 259 households could have been assisted with the same level of subsidies.

On the basis of our preliminary work on the other seven projects we are reviewing, we are finding that it would have been more economical to have relied on existing rental housing using Section 8 certificates rather than producing additional units through the combination of moderate rehabilitation and tax credit subsidies. For these projects, approximately 850 additional households could have been assisted if certificates had been available to local public housing agencies for housing low income families.

Mr. Chairman, I have brought two charts (Attachments I and II) that provide specifics on the Sierra Pointe project. However, before discussing the charts, I would like to highlight key provisions of the Moderate Rehabilitation and Tax Credit programs.

MODERATE REHABILITATION AND TAX CREDIT PROGRAMS

The Moderate Rehabilitation and Tax Credit programs were intended to increase the supply of rental units for low-income families. Under the Moderate Rehabilitation Program, owners agreed to upgrade substandard rental housing in exchange for 15 years of guaranteed, project-based Section 8 rental subsidies. For low-income housing, where the prospects for profit from operations and gain on the sale of the property are limited, tax benefits have historically been very important in inducing developers to build or rehabilitate such housing. Under the Low-Income Housing Tax Credit Program, owners are encouraged to develop low-income housing through reductions in their overall tax liability.

DEVELOPER CASH FLOWS GREATLY EXCEEDED PROJECT COSTS

The developer of the Sierra Pointe project, like the developers of the other seven projects we are reviewing, used subsidies offered under the Moderate Rehabilitation Program along with tax credits to generate substantial cash flows. The Sierra Pointe project consists primarily of 2- and 3-bedroom units and was placed in service in 1987.

Our first chart, which is also attachment I to my statement, presents our cash flow analysis of the Sierra Pointe project. The principal sources of funds were a mortgage loan in the amount of $7.4 million and tax credit proceeds, which we have estimated, after syndication, to be about $2.3 million. Actual tax credits awarded to the project will result in $5,788,360 over a ten-year period.

Our chart shows that $3.7 million of these funds were used to acquire the project and another $4.5 million to rehabilitate it. In addition, we estimated that the developer received a fee of about $900,000. This estimate is based on what the state of Nevada typically allows developers to claim for reimbursement for this kind of project. When these principle uses of funds are combined with other adjustments, the estimated proceeds to the developer amounted to about $1.8 million or 22 percent above the costs to acquire and rehabilitate the project. On a per-unit basis, this is approximately $11,400.

There are no standards or guidelines governing the amount of proceeds a developer can realize above the cost to acquire and rehabilitate these types of properties. However, we believe the Sierra Pointe developer, as well as most developers of the other projects we reviewed, realized cash flows that were greater than what would have been required to ensure project feasibility. The developers realized sizeable cash flows while assuming less risk than is usually encountered in typical development activities. They assumed less risk because the rents were guaranteed by HUD and the mortgage loan was co-insured by HUD.

HOUSING SUBSIDIES WERE USED INEFFICIENTLY

The inefficient use of federal housing subsidies has serious repercussions on low-income families. As shown in our second chart, and in attachment II to this statement, rents at Sierra Pointe for a 2-bedroom unit were established at $596 per month. Section 8 certificate subsidies at this rent level, when adjusted for inflation and combined with awarded tax credits, will total about $23 million over the next 15 years. By contrast, other rental rates in Clark County for 2-bedroom units were about $425 per month. Subsidizing rents with certificates and adjusting for inflation would require about $9 million in federal financial assistance for 160 families over the next 15 years.

Looking at the situation another way, our analysis shows that based on the average annual voucher/certificate subsidy of about $3,300 per household for the area, about [illegible] 419 families could have been assisted for the same amount of federal subsidy ($23 million) required to assist 160 families at Sierra Pointe. This represents an increase of about 162 percent or 259 additional households.

Using housing vouchers/certificates is generally a more efficient and prudent method than producing additional units when there are sufficient vacancies in the market. As I mentioned earlier, we estimate that Clark County had upwards of several thousand vacant rental units during the periods before, during, and after Sierra Pointe was developed. We believe that the 160 families housed at Sierra Pointe could have been absorbed in suitable rental housing already available in Clark County.

CONTROLLING THE AMOUNT OF PROJECT SUBSIDY

We have demonstrated the result of awarding financial assistance to projects without consideration of the actual need for assistance. Until recently, moderate rehabilitation and tax credit subsidies were awarded with little regard for the total amount of combined subsidies or the actual amount of project subsidy required to ensure project feasibility. In many instances, rental subsidies were awarded up to the maximum amount permitted by regulation, and tax credits were awarded on a "first-come, first-served" basis up to the maximum amount allowable.

Recent changes to both programs have limited the amount of subsidies allowable and the way the subsidies can be used. Section 127 of Public Law 101-235 changed elements of the Moderate Rehabilitation Program concerning minimum rehabilitation costs, the number of units (100) in a rehabilitation project that can be assisted, the amount of rental subsidies that can be awarded to a project when tax credits are also used, and the way the program awards are made. Moreover, Section 7108 of the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239), which extended the Tax Credit Program through calendar year 1990, placed greater responsibility on state credit-allocation agencies for administering the program and prohibited using the Tax Credit

Program in combination with the Moderate Rehabilitation Program. Aside from these legislative changes, we believe as HUD revises its procedures for awarding moderate rehabilitation subsidies that it will need to ensure that these subsidies are targeted to market areas where there is a demonstrated need to increase the supply of rental housing.

We believe these actions will help to prevent the kinds of problems we have outlined here today and allow limited federal funds to assist the greatest number of households possible.

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Mr. Chairman, this concludes my statement. I would be pleased to respond to any questions that you or members of the Subcommittee may have.

ESTIMATED CASH FLOW - SOURCES AND APPLICATIONS OF FUNDS

SIERRA POINTE

	SOURCES OF FUNDS:		
(A)	Mortgage Loan (from HUD Form 2580)	$7,401,300	
(B)	Tax Credit Proceeds (1)	2,344,286	
(C)	Other	0	
(D)	Owners Cash Investment (2)	54	
(E)	Total Sources of Funds		$9,745,640

	APPLICATION OF FUNDS:		
(F)	Acquisition Costs (from HUD Form 2264)	$3,700,000	
(G)	Development Costs (from HUD 2331A)	4,497,415	
(H)	Developers Fee (3)	899,483	
(I)	Estimated Escrows and Prepaid expenses (1.5% of Mortgage Loan) (4)	111,020	
(J)	Gross Total Applications	9,207,918	
(K)	Less: BSPRA (from HUD Form 2331A) (5)	(383,855)	
(L)	Net Total Applications of Funds		$8,824,063

	PROCEEDS TO DEVELOPER AT COMPLETION OF DEVELOPMENT	
(M)	Estimated Proceeds To Developer (E-L+H-D)	$1,821,006
(N)	Estimated Proceeds To Developer Per Unit (160 Units)	11,381

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(1) Cash value of tax credit proceeds result from developer sale of ownership interest in project. Tax credit data is not subject to 26 U.S.C. 6103. Assumptions regarding value of tax credits as follows:
  (A) Syndication proceeds equal 45% of awarded credits
  (B) Credit proceeds disbursed to project owner over three years, discounted at 10% per year.
  Actual tax credits awarded were $5,788,360

(2) Estimated cash requirements at initial endorsement exclusive of letters of credit required for mortgage closing. For this project, owner also provided $445,182 in letters of credit.

(3) Developers fee was estimated at 20 percent of development cost.

(4) Estimated amount on the basis of standard industry practice.

(5) BSPRA = Builders and Sponsors Profit and Risk Allowance.

GAO Subsidy Comparison Estimates for Clark County, Nevada — 1987

	Sierra Pointe Project (Using Tax Credits)	**Other Section 8 Certificate Projects**	**Differences**
Rent (2 Bedroom)	$596	$425	$171
Subsidy Over 15 Years (160 Assisted Units)	$23,000,000	$9,000,000	$14,000,000
Number of Assisted Families	160	419	259

Senator GRAHAM. Thank you, Mr. Ols.

Mr. Cottrell, Mr. Ols made some statements relative to the housing market that existed in your community in the period when decisions were made to go forward with Sierra Pointe.

Do you agree with those statements?

Mr. COTTRELL. Yes. Those are essentially the facts as we understand them. There are a couple of points I'd like to make.

There's no way of determining how many, if any, of that 4 to 8 percent vacancy factor or 9 percent I believe he said in that particular zip code area or whatever were available to low income people. These are simply vacancies all through the whole gamut of housing and in our housing market, like most housing markets, there was very little, if any private sector housing available to low income people particularly if they're only going to pay 30 percent of their income as rent.

The second thing is we didn't have access to 500 or 300 or 200 certificates or vouchers. We're talking about, as I said, scraps and bones and here was an opportunity for us, as responsible local people trying to serve the people that we're charged with serving, to gain some number which turned out to be 160 of decent, safe and affordable units. So we grabbed at that opportunity.

Senator GRAHAM. If you had the option of diverting the same dollars that were used to subsidize Sierra Pointe into additional section 8 vouchers, would you have elected that option?

Mr. COTTRELL. We would certainly have considered it because the Mod Rehab Program is 10 times the work for the local agency and we don't get any extra fee. We get the same fee from HUD as if we just put these certificates out on the street.

Let me point out that under the certificate program as it then was and under the Mod Rehab Program we are guaranteed those units for 15 years. Under the present certificate program and the voucher program as it has been since its inception, we're only funded for 5 years at a time and the residents are only guaranteed that they are going to be in that particular unit for 1 year at a time.

So this was an opportunity to provide not only 160 additional units but 160 units that we knew would be available to the families we serve for at least 15 years.

Senator GRAHAM. You gave us as one of the concerns the fact that the housing authority does not receive any additional fee under Mod Rehab and therefore you would not have had any bias against shifting away from that toward section 8.

I would assume that the goal is to use the public subsidies that are available to achieve the maximum number of families able to secure adequate housing.

Mr. COTTRELL. Well, yes, of course. As a matter of public policy. That's certainly something we would subscribe to.

Senator GRAHAM. And you're saying that the current system does not allow you to make those kinds of tradeoffs as between increasing the supply of housing through funding a development project as opposed to increasing the demand by reducing the economic disabilities of a low income family through a program like section 8.

Mr. COTTRELL. Well, you said it was a system. I'm not sure it's a system. It's a bunch of bits and pieces of leftover programs that haven't been killed or drastically emaciated. So there really is no system. I was very interested in the comments on the previous panel where they were saying that the basic problem is that there is no coherent, cohesive, comprehensive national policy on housing.

It seems like every Congress has some ideas about some new programs and every HUD administration wants to administer whatever they have differently from what the last guy did. So we at the local level are faced with a constant churning of programs and not only churning of programs but drastically reducing the resources that are available to us.

Let me say that my staff 100 percent unanimously would vote to go for existing certificates out on the street any day over Mod Rehab because it's just a whole lot more work for everybody and as far as the local agency is concerned the only thing it did for us was to give us 160 units over a 15-year guarantee.

Senator GRAHAM. If you had issued an additional 259 section 8 certificates worth $425 a month, do you think those 259 families could have found housing in Clark County?

Mr. COTTRELL. Well, that's a hypothetical question, but given our market and given our fair rent levels, it's probable that they would have. Now maybe not 259 all at once, but certainly 259 over some reasonable period.

Senator GRAHAM. Senator Mack.

Senator MACK. I want to focus for a few minutes on the $23 million. What are you calling that $23 million?

Mr. OLS. That's over the 15-year period. That will be the governmental subsidy including tax credits, the actual subsidies of the project itself over the whole 15-year period and what we do is adjust it for inflation and spread it over the whole period of time and then that's how you come up with $23 million.

Senator MACK. What role did the tax credit play in that $23 million, how much of that?

Mr. OLS. That's $5.8 million. That's the total tax credit. When you calculate that out, its the total Federal subsidy that's coming out of the Treasury.

Senator MACK. So it is $5.8 million over 15 years.

Mr. OLS. Over 10 years; 10 years for the tax credits.

Senator MACK. And what other major subsidies are included in that $23 million? We've got $5.8 in the tax credit.

Mr. OLS. That's the rent subsidies that are given to the project by the moderate rehabilitation program. The $596 that we're paying for a 2-bedroom unit and for the other 160 units.

Senator MACK. Reading through some of the things that have been written by the General Accounting Office about eight projects that they put together, the fact that there was 9 percent vacancy, that they could have used other programs to do a better job, the thing that's beginning to concern me here—the 9 percent if they had had vouchers or certificates, I think they probably would have used them. It certainly isn't their fault.

Mr. OLS. I'm not saying that it's their fault. When we were asked to take a look at what you could have gotten under a different scenario than using the Mod Rehab Program, that's how we calculate it out. The certificates would be a cheaper way, a more efficient way to house the 160 families. That's really all we were trying to calculate.

Senator MACK. I think Senator Graham tried to get the earlier witnesses to come up with some idea of what the subsidy was, which I assume is probably something similar to that $23 million, the calculation of.

Mr. OLS. That's right.

Senator MACK. Now I'm not sure all of the things that are included in this particular project, but I know from the first discussion we had the tax-exempt status of the bonds, which I assume would have to be calculated out over a period of years.

Mr. OLS. There are no other subsidies like the St. Louis project.

Senator MACK. Well, you're getting to my point. There is the guarantee, however. How about CDBG funds?

Mr. OLS. No.

Senator MACK. No CDBG funds?

Mr. OLS. Not to my knowledge, no.

Senator MACK. How about UDAG?

Mr. OLS. No.

Senator MACK. No UDAG.

Mr. OLS. The gentlemen to my right and left could correct me if I'm wrong, but to my knowledge there is none.

Senator MACK. I think you're right. And no investment tax credits. There's a tax credit under the 1986 tax law but not the old investment tax credit.

Mr. OLS. No, because this came on line after that.

Senator MACK. Do you have any idea what that tax subsidy might have run up to?

Mr. OLS. Well, $5.8 million.

Senator MACK. No. I'm talking about the first project we were discussing this morning, what those subsidies could have amounted to.

Mr. OLS. That was the first I had seen that project.

Senator GRAHAM. If I could, I'd like to ask Mr. Ols if maybe you could take the information provided on the brewery and this and attempt to do a calculation of those subsidies, including the subsidies that derive from preferential financing as a result of either insurance or, in this instance, coinsurance.

Mr. OLS. We'll be glad to, Mr. Chairman.

Senator MACK. I guess what I'm getting at, and I really don't know as much about this project yet as I do about the earlier one, but at first glance it seems to me—I guess one other point I should make first—are all 160 units of these for low income?

Mr. OLS. Yes.

Senator MACK. As compared to the earlier one for only 45, a third?

Mr. OLS. That's a key difference between those two projects from my understanding of hearing the gentlemen from St. Louis speak of them.

Senator MACK. It seems to me at first glance that this is a much more efficient use of subsidies, if that's what we want to call it. Did you tell me that the earlier one was $65,000 a unit cost as compared to $23,000 here?

Mr. OLS. Yes. That's what the other gentleman was saying, if you compute out his development cost that's what it would come out to be. This is $28,000 that we computed out for developmental costs.

I think developmental costs are a tough one because you remember in the other example there was $11 million, if I remember the figures right, for developmental costs, which was very high, but it depends on how old the building is. It depends on how much you've got to gut it, redo it. There are a lot of things that would come into what is the per unit cost. Even under the Mod Rehab under that system that was in place, I think the law was $1,000 per unit as a minum. As the chairman asked, is that more than Mod Rehab? And I think the response—and I would agree with it—there was no other program to construct units. That was all that was available.

Senator GRAHAM. I would like to go back and pursue the genesis of this project and particularly picking up on the statement that was just made as to the appropriateness of this project for Mod Rehab, given its original purpose which was to provide for relatively small developments with limited amounts of rehabilitation required to make them habitable.

How did this project of 160 units at $28,000 development costs per unit perceived as being an appropriate project for Mod Rehab? I might ask that question of Mr. Abrams, who conceived the idea, and Mr. Cottrell, who was part of the decision-making process.

Why did you think, Mr. Abrams, that Mod Rehab was an appropriate area of subsidy to apply for?

Mr. ABRAMS. Well, Mr. Chairman, when we were looking for projects in the Clark County, NV area, we were looking for projects that fit in with the program and particularly with some of the policy objectives, one of which was to provide large bedroom units. This project, as Mr. Ols pointed out, has 60 three bedroom units and the balance two bedroom units.

One of the problems with this program as well as other programs is that most of them are directed toward the elderly and developers prefer to build one bedroom units because they are much easier to manage and you don't have children.

This project was in a good neighborhood for a family project, near schools and shopping. We thought that the project would have a good residual value at the end of the 15-year subsidy period because it was in a good neighborhood and it was desperately in need of rehabilitation. If my memory serves me, most of the units in this project were not eligible for people with certificates because they didn't meet the minimum housing quality standards that are required for people with certificates or vouchers.

The Mod Rehab Program is supposed to concentrate on buildings that need rehabilitation. It is not a pure housing subsidy program. The intent is to rehabilitate the Nation's housing stock in addition to subsidizing families. That's why it is more expensive than certificates and we thought that this was as appropriate a project for Mod Rehab as we were going to find.

Senator GRAHAM. But the emphasis is on the word "moderate" because there was a program previously which was—in fact, it was the predecessor of Mod Rehab if I'm correct, which was for larger scale rehabilitation—then this program came subsequently to be available for smaller scale, lesser rehabilitation cost projects. Is that an accurate statement of the history of these housing programs, Mr. Ols?

Mr. OLS. Yes. There used to be a program called substantial rehabilitation if I'm not mistaken.

Senator GRAHAM. And the question is, did you consider applying under the substantial rehabilitation project?

Mr. ABRAMS. No, because the definition of what is a Mod Rehab project is the fair market rents for Mod Rehab published in the Federal Register and any project that falls within the Mod Rehab rents is, by definition, a Mod Rehab project. There are substantial rehabilitation rents also published which are much higher.

Senator GRAHAM. When this project was submitted to you, Mr. Cottrell, did you feel it came under the category of a Mod Rehab project?

Mr. COTTRELL. Mr. Chairman, the only threshold the housing authority was involved with was to ensure that it involved at least $1,000 per unit. There's no upper limit under the Mod Rehab Program on what you could do. I assume from the developer's point of view obviously if the whole thing didn't pencil out it wouldn't go forward, but our concern was first that it meet that criteria. There was no question in this case. We were very familiar with this particular project. It was then I believe 24 years old. Under the old section 23 program we had had people in this development in the early and mid or late 1960's I guess, but as Mr. Abrams had pointed out, over a period of years it had not been properly maintained. We would not certify it as qualified under the section 8 program because it did not meet housing quality standards.

So we were aware of the property. We were aware of the very desirable location. But we were also aware of the fact that it did need rehab. It did need roofs. It did need replacement of the mechanical systems, air-conditioning and heating. Of course, in our area air conditioning is extremely important. Those units were 24 years old.

So we had our own people do a very thorough inspection. His architect did a very thorough inspection. And basically we agreed up front, although we had some later differences about eligibility of costs and unit cost on some things, but up front we had no argument with what they were proposing to do in the way of rehab because we agreed that that was what was necessary.

Now we had no way of knowing whether it was going to be $8,000 a unit or $58,000 a unit at that point because this was all preliminary when we were talking about the program as a concept as a possible project.

Senator GRAHAM. One of the questions which has been raised in some of our previous hearings has to do with whether there was really a competitive situation in terms of allocating Mod Rehab and some concerns have been expressed about this project based on the fact that there was a relatively short period of time available for developers to come forward with their plans, that there was a matching of the number of units which this particular developer was proposing and the number of units which came down from Washington.

I understand that originally you had requested 200 units. What came down was 160 units and that was the number of units that this developer was proposing to build.

Are you satisfied that there was a free and fair competitive marketplace in which other developers who had similar hopes of rehabilitating housing in your jurisdiction could have competed to have been selected?

Mr. COTTRELL. Yes, Senator. You noticed in my prepared statement that I quoted a lot of dates and times and that was in part to document the fact that we did provide—in answering your specific question—we provided what we felt was a reasonable period of time.

Senator GRAHAM. What was the amount of time available from the first public announcement that you were going to be soliciting proposals and the closing date for submission of indications of interest or applications?

Mr. COTTRELL. Well, the advertised period was a 30-day period if that's what you mean by the first public announcement.

Senator GRAHAM. The fact that you only developed one applicant and apparently that applicant had prior to the announcement of the fact that these units were going to be available had done a substantial amount of work and from your agenda had already had some contacts with your office, do you feel that says anything about the adequacy of either the notice process or the time available to respond?

Mr. COTTRELL. Well, it may, but I think equally important is the fact that you have to understand that even though everybody has heard of Las Vegas we are a relatively isolated community. We are 500 miles from Salt Lake City. We are 450 miles from Reno. We are 300 miles from Phoenix. We are 300 miles from Las Angeles and there's nothing in between except sand and sagebrush basically.

We have no local rehab community and there's nobody in the local area who does rehab. In part, that results from the fact that we are a very young and rapidly growing community. Eighty percent of all the dwelling units in that metropolitan area of 750,000 people are less than 20 years old. There's not a whole lot to rehab so there's no local rehab industry.

Now we were contacted by two other developers, one from Salt Lake City and one from Visalia, California who had done, according to his statement to us—had done considerable rehab work in southern California. I think that is an indication that other people were aware of the fact that we were advertising. Now why they didn't submit proposals I have no way of knowing.

Senator GRAHAM. Senator Mack.

Senator MACK. Thank you.

I want to go back to one of these charts over here. Mr. Ols, when you made the comment that there was no risk involved, I couldn't help but notice that there were certain heads and certain body reactions to your comment and I assume that you were making that statement based on your owner's cash investment of $54, very limited risk or no risk and that's exactly right, because of what we're putting in. That's right. Based on $54.

Mr. OLS. Right.

Senator **Mack**. I would like to have some reaction from those of you who I saw heads in obvious disagreement with the comment that was made. I would like to get your input as to why you disagree with that. And I assume you disagree also with the $54 as the owner's cash investment.

Mr. **Abrams**. Senator, I will respond.

The figure of $54 Mr. Ols is using is off and I think part of the problem with understanding the numbers that go along with the project is that we have three different entities at different development levels. We have an owner, a developer, and a construction entity and there are several different programs. You've got FHA, insurance, Mod Rehab, and the tax credits, which all come up with different numbers. And then the FHA process develops forms—has forms that are used at different stages in the project: at the initial endorsement, which is the initial closing of the mortgage. Then there is the final closing and then there are costs, sort of in the meantime, there is cost certification. And the numbers come from different stages in the process somewhere.

The $54 is a number representing what HUD recognizes at a certain point in the process. After discussing with your staff the interest in these numbers, I have tried to take them from the different entities and consolidate them. So, with the caveat that I can't certify to them, there is roughly invested in the project the following sums of money.

Senator **Mack**. Could I interrupt you just for a second before you get into that, because I want to ask Mr. Coe a question related to——

Would it be your practice—again you say you've done some $600 million of the coinsurance program and have not made a claim yet. I would assume that one of the reasons you have not made a claim is that you have—you want to make sure that those who you are working with have enough at risk to protect that investment. I guess the other way I would ask the question is: Is it your opinion that there is only $54 of equity in this deal?

Mr. **Coe**. Well, there are often significant equity requirements which do not show up in FHA processing.

Senator **Mack**. Could you give me an example——

Mr. **Coe**. Well, for instance, there are certain reasonability caps placed on legal fees for instance and ofttimes it will cost a developer two or three times the legal fees that we recognize in the mortgage to close a loan.

There are also—there is a large danger of overruns in many of these projects, especially rehabilitation projects where, once you get into actually doing the work, you find that there is hidden water damage or something you thought could be repaired has to be replaced. And because of overruns on this job, the owner had over $400,000 from our perspective, from an FHA perspective, had over $400,000 in cash out of his pocket into the project to pay for these various overruns. And also, going back to his risk statement, they had several hundred thousand dollars in letters of credit that were up during the construction period and 1 percent of the loan is ongoing at risk for 3 years, in cash. So there are other things that go into that than are just shown on the FHA format.

Senator **Mack**. Mr. Abrams, go ahead. I'm sorry.

Mr. **Abrams**. Before the initial closing in December 1986, we had approximately $230,000 expended that was contingent on the closing. It was contingent on FHA initial endorsement and contingenent on the housing authority executing a contract to enter into the subsidy payments.

Before the final endorsement—and of course, once we close with FHA, a lot of that money was reimbursed to us. Most of the money was reimbursed.

In June 1988, before final endorsement with FHA, we had $405,000 in cash invested in addition to mortgage proceeds. After the final endorsement by FHA—I think according the HUD forms, the HUD 2580, we had $507,000 in cash invested in the project. By our numbers we had $541,000 because there are numbers that HUD doesn't recognize.

Since then, we've put another $180,000—and some of these numbers—you can't add them all up. But in 1988 we put $33,000 in the project; in 1989, $150,000 was spent in the partnership.

In addition to the fact that we have ongoing guarantees, as Mr. Coe said, we have a 1-percent guarantee to Ginnie Mae. And in addition to that, we have an operating deficit guarantee and a guarantee that these credits will remain in existence for 15 years, because although the tax writeoffs are taken over 10 years, the credit obligation is for 15 years, the same as the subsidy.

We are doing the asset management on the project and are obligated to do it for 15 years. The project has not had—it had a negative cash flow in 1988 of $55,000 and we estimate on the preliminary numbers that the cash flow for 1989 may be as high as $17,000; however that money goes to the people who bought the credits because, in addition to buying the credits, they also bought the cash flow and they bought a portion of the residual value of the project at the end of the 15 years.

So, I would take issue with the saying that there is no risk.

Senator **Graham**. Mr. Queenan, would you want to comment on——

Mr. **Queenan**. I would agree Mr. Abrams and note also that this was the pre-1986 project when we first conceived of developing it. There was not a tax credit program in existence at that time. Mr. Abrams, Mr. Win and I developed the property on the assumption that there would be positive cash flow over the 15-year period of subsidy and beyond that the term of the life of the mortgage.

In addition, we also valued the residual value of the property. We were looking again for property in Clark County that had a strong upside potential and we were not looking at the use of tax credits, nor were we looking at the combination of other federally assisted programs, for example the Block-Rand program.

Senator **Mack**. The tax credit issue now, what you are saying is that this project was put together prior to 1986, the Tax Reform Act?

Mr. **Queenan**. That's correct, Senator.

Senator **Mack**. So you were not counting on that as——

Mr. **Queenan**. We were not, Senator.

Senator **Mack**. But wouldn't you have been eligible for whatever the previous tax credit, investment tax credit——

Mr. QUEENAN. That was being terminated at the time, Senator. And the new program, the tax credit program, was picking up, although it was not yet legislated.

Mr. ABRAMS. We were on notice that the accelerated depreciation and the 15-year life and the 5-year writeoff on rehabilitation under the pre-1986 Tax Code were being eliminated. We were not aware that there were going to be credits and were proceeding in that limbo period.

Senator MACK. So, in other words, you got a windfall from the 1986 Tax Act, is that right?

Mr. ABRAMS. Correct.

Mr. OLS. That's correct.

Senator MACK. And again, you had no idea that that was going to be there?

Mr. QUEENAN. We did not.

Senator GRAHAM. If it is acceptable to the members of the panel, Senator Mack and I can go about another 20 minutes and I think we could finish our questions by that time, which would mean that when we came back after lunch at 2:30, we would be with panel 3. Can you stay another 20 minutes?

Mr. COE. Yes, sir.

Senator GRAHAM. I would like to focus on the rent.

Mr. Coe, from the material that you provided us, you indicate that, as the coinsurer, you related to the local public housing authority and to HUD in the process of determining what the fair market rent would be. Is that a correct statement?

Mr. COE. Yes. Our responsibility was to determine the rents for mortgage insurance processing for the debt service approach to the mortgage. And therefore, as part of our normal valuation processing, we commissioned a rent comparability study. It was a PHA or housing authority's responsibility to determine the contract rents for the section 8 contract. That contract is between the housing authority and the developer, as overseen by HUD.

Now, if the housing authority, in order to make their determination of these rents, chose to use our comparability analysis, then that was their decision. And, in fact, they did that because HUD told them in writing that a certain appendix to one of the HUD handbooks applied, called appendix 33. And that, among other things, allows a PHA to use a rent comparability study to determine the contract rents.

I would like to add two things to that. First, our commitment for insuring or coinsuring the loan was contingent upon the housing authority's determination of rents and not vice-versa. And, finally, it is very important to note that our comparability study was submitted to HUD and was approved without exception.

Senator GRAHAM. Well, just looking at those numbers on Mr. Ols's chart, [attachment 2] if other section 8 certificates were $425 and Mr. Cottrell indicated earlier that he felt that if $259 additional section 8 certificates had been available, that those families could have found housing in this area. How could a rent level $171 a month above that figure have been the fair market rental?

Mr. COE. Well, HUD defines the Mod Rehab fair market rent as 120 percent of the normal fair market rent.

Senator GRAHAM. Well I thought the 120 percent was if there was a showing that was required. Are you saying that's just an automatic 120 percent?

Mr. COE. Well, the 20 percent bonus is to amortize the cost of the rehab of the property. So, you know, the purpose of the program was not to—unlike a voucher where you supposedly have a unit which is already rehabbed or is in good condition, the purpose of this program was to take a project which is is poor condition and pay for the rehab through this 20 percent bonus.

Senator GRAHAM. Well, even if 20 percent of $425 is roughly $85, that's half of the $171. How was the difference between 120 percent of $425 and the ultimate $596 arrived at?

Mr. TANKER. If I can add a couple of things to what Mr. Coe said to answer your question.

First, the determination of the Mod Rehab rents is dependent upon the lower of rent comparability or cost justification. That is, the housing authority will look at the amount of costs needed to rehabilitate the project and add to that, the debt service for those costs, onto the costs if they hadn't done any rehabilitation at all, just buying the project and maintaining it with normal expenses.

As far as the difference in rents, we of course don't know where Mr. Ols got his rents or his comparability; we haven't discussed it with him. But the difficulty in making any rental comparisons at all is that you never find two projects next to each other that are identical. And so, what you are left with is appraisal as an art and you try and take two projects that are comparable ——

Senator GRAHAM. Well, I happen to be in the real estate business and have done a lot of this. And if you have 80,000 rental units in Clark County, which Mr. Cottrell said they had, it does not take a rocket scientist to figure out within a reasonable range what the fair market rental is for various types of rental housing. Agreed? And I still don't understand how there could be what is approximately a 40 or 50 percent difference between what section 8 certificates Mr. Cottrell said could have purchased housing in Clark County and the level set by your appraiser as the fair market rent. I mean, even taking into account the fact that you bumped it up 120 percent to begin with.

Mr. COE. I would like to point out that our information about vacancy rates in the area are that they were 3.4 percent at the time of the closing of this project. This comes from the University of Nevada, Las Vegas postal survey. And, indeed, in the year prior to construction or rehabilitation of the project, rents had increased 4.3 percent in the area. In the year after, rents increased 4.69 percent. Now if there were 9 percent vacancy rates in this area, I don't think you would have had those kind of rent increases, it is just supply and demand.

Senator GRAHAM. What did you find to be the fair market rent for units that were comparable and would be competitive with those at Sierra Pointe.

Mr. COE. We found that the 497 was a comparable rent and HUD allowed you to adjust upward of that number by 20 percent to a amortize the cost of the rehab.

Senator GRAHAM. How would you get from 120 percent of $425 all the way up to $596?

Mr. **Tanker**. What we can do is to do an analysis of this for you and submit it to you.

Senator **Graham**. I notice that you used an appraisal firm from Knoxville for this purpose, is that correct?

Mr. **Tanker**. Correct.

Senator **Graham**. Mr. Cottrell, would it be normal for an appraisal firm whose objective it is to determine what the fair market rental rates in Clark County, NV, are to come from Knoxville?

Mr. **Cottrell**. Well, we wouldn't have used one from Knoxville, but this was the first time we had been involved in Mod Rehab and——

Senator **Graham**. But this is not an esoteric issue here. This is an issue of determining what the fair market rental rates are in Clark County.

Did you have any role in accepting this firm from east Tennessee as being an appropriate one for purpose of arriving at that determination?

Mr. **Cottrell**. No, we had no role in that determination.

Senator **Mack**. Do you think you should have had a role in it?

Mr. **Cottrell**. Well, Senator, these—the basic problem with these programs, as I alluded to earlier, is that you've got two different HUD programs that don't gee-haw, if you can relate to that old term. They just don't work together. And the basic problem is—and let me personally in response to your question and partially in response to them. We had received a letter from Mr. Abrams written January 5, 1986, and I just want to read this one section, because it relates to this one basic question about rents.

Paragraph six of appendix 33 states that: "For Mod Rehab insured projects, the rents calculated by the PHA"—that's us, the housing authority—"using the procedures contained in handbook 7420.3, including the policy concerning work items eligible for amortization for contract rents will be used unless the field office manager or supervisor determines that such rents are inappropriate for mortgage insurance purposes. In such cases"—in this case, Benton in the role of HUD—"Benton is hereby delegated the authority to waive the regulations in order to calculate the contract rents in accordance with the mortgage insurance procedures."

Now that was what was presented us by the developer. We immediately contacted our regional office and had a series of phone conversations with the folks up there who, unfortunately, didn't know much more about Mod Rehab than we did because there hadn't been much of it and as has been stated earlier a lot of the HUD people that did know something had bailed out of HUD, had retired or gone to the private sector or whatever. But we did get an answer back on that specific question dated January 29, 1987 signed by Ronald H. Halpern, who was then director of the Housing Development Division of HUD in Region IX.

> Dear Mr. Cottrell: This is a followup to a recent telephone conversation you had with Diane Brambila of my staff regarding the role of the coinsurance lender in development of the captioned Mod Rehab project. Since the developer elected to obtain financing from a FHA-HUD approved 221D multifamily coinsurance program lender, the roles which HUD would assume pursuant to appendix 33 of the HUD Moderate Rehabilitation handbook are assumed by the coinsurance lender.

Now that was as close as we ever got to an answer from HUD about what our role was in rent determination and what that said was that in these circumstances, since a coinsurer was involved, then the coinsurer acting for HUD had the right to substitute the rents determined under the coinsurance program for those that would have been determined under the section 8 program.

Senator Graham. Senator Mack.

Senator Mack. Well, I only have one further point to follow up on and it's that it seems to me that we had just two different programs. This is oversimplifying. You could possibly have a situation where you would have liked to have used section 8 vouchers or certificates to provide this additional housing or you could use the Mod Rehab which was apparently not the most efficient way of going about it. But because the vouchers weren't available to you, feeling it your responsibility to add an additional 160 units to be available to low income, decided to go with the Mod Rehab Program.

Mr. Cottrell. Yes, sir. I would agree that's an oversimplification, but I would also agree that that was why we chose to use it. That was the only vehicle that was available.

Senator Mack. I guess this goes back to the earlier discussion that we had with the first group. What suggestions do any of you have as to how we might be more effective in seeing that the limited resources go to provide the kind of housing that is needed in this country? I'll just throw out one suggestion and then I'd like to get your different thoughts. It seems to me that before funds are allocated for different projects that somebody ought to ask the question, is this in fact the most effective way? If the decision was made that we're going to provide Mod Rehab funds, therefore somebody believed there was a need to make 160 units available for low income housing, it seems to me that the next question that ought to come out is, well, now that we've determined that there's a need for 160 units out there, is the Mod Rehab really the best way or would we be better off to give the housing authority additional vouchers and certificates and let Mod Rehab funds go to some other place that, in fact, would be the most effective and efficient use of the funds. Does that make any sense?

Mr. Abrams. Senator, there are two parts to your question. As far as the allocation formula, you should be aware that the statutory allocation formula for all subsidized programs gives great weight to the older parts of the country. It affects negatively Nevada and Florida and other areas that have had housing predominantely built since 1940 because the statutory formula requires that weight be given to the presence of housing built pre-1940. That is the allocation problem.

The second problem is what type of housing support and to what we've been saying here, and the first panel, you have to decide whether you're running a housing program or an urban renewal program or a rehabilitation program.

If you are concerned with housing, you should give everybody vouchers. If you have other policy objectives, then you go to Mod Rehab or the other programs that were discussed this morning.

Mr. Ols. I might add, Senator, that I think your characterization in my mind is right on track as far as what ought to be done. I think the first panel got to that point. We need to determine at the local level what is our best need. Is it Mod Rehab as Mr. Cottrell said? And he went and got what he felt he needed. He had a waiting list. He needed 160 units. He'd take even more if he could have gotten those.

We don't have the opportunity—or I don't think the locals do as far as housing policy as far as what is best for that area and it will be different in all areas. As Mr. Abrams just said, the 1940 preconstruction does favor the East Coast area and there's no question about that. That comes into that formula of what you would do.

Now our hypothetical example is saying if everything else was equal and I could make that judgment, what should I do? Well, you can do it at a lot less cost or you could provide more units for the same amount of money. That's really what we were trying to demonstrate here between these various programs. Even within HUD many of the program people do not talk to other program people which causes problems. In other words, what's their view of the objectives and what they're trying to serve versus what some other unit or some other program is trying to serve. They may have a little different agendas to go after which causes, even within HUD itself, some problems.

So I think you have to look at making that determination. One of the things I concluded in my prepared statement was we hope that if HUD revises the Mod Rehab regulations and rules that they would have what we consider to be demonstrated need for that project which then would force at least some consideration of that aspect and that would be my suggestion of how to try to get a handle on the situation.

Senator MACK. Does anybody else want to comment?

Mr. COTTRELL. Mr. Chairman, a couple of comments. We've talked about certificates and vouchers, but we haven't even talked about the oldest and what I believe to be the most cost-effective program and that's the conventional low-rent public housing program. It has been very successfully pursued in this country since 1937. You always hear about Pruit-Igoe which was mentioned on the previous panel as a horror story, but the vast majority of public housing in this country is safe and decent and well-managed and it's certainly affordable. So I would go even further than talking about vouchers and certificates.

The other general comment I'd like to make is all housing is local. Housing problems and opportunities exist in a given setting. You can't pick it up and transfer it from Miami, FL to Anchorage, AK. You can't do that. You've got to work in that local market.

So there has been a determination over the years with various housing programs that they were necessary. Congress has determined that here was a need that wasn't being met, so an additional program has been added to the pot. The problem is, the pot is smaller, much, much smaller—70 percent smaller in 1990 than it was in 1980. So even while some of the programs are still around, they are funded at very, very low levels and a number of those programs have been very successful. So I would caution that we not throw the baby out with the bathwater. We need a mix of programs. In some communities you could do the whole thing with section 8 certificates or vouchers, although some of us who work with vouchers have some problems with that program. But certainly something, no matter what you called it, that was like the certificate program will work very well in some communities. In other communities where you have extremely tight rental markets and very low resources of low income housing you need construction. If you don't have construction you're not going to serve low income people.

So my recommendation would be to not look at one program as a panacea for the whole housing problem but to look at the mix. Let's don't kill off programs that have been successful, but try to infuse some additional resources.

Senator MACK. Again, I think the message that is coming across to me is getting back to all housing is local, is that the decision about how to use those resources ought to be made at the local and not created, if you will, programs created at the Federal level and, in essence, forced on you. Is that what you're saying?

Mr. COTTRELL. That's one aspect of it. The major thing is you can't do anything if you don't have anything to do it with. That is kind of the position we are in these days compared to what they were, say, 12, 14, 16 years ago.

Senator MACK. Just so that I understand where you are coming from, what you are saying then is just give us more money in these different programs and we will solve these problems.

Mr. COTTRELL. I am not saying you just throw money out there and it will solve problems. I am not saying that. What I am saying is that the proportion of the gross national product of this country that is being devoted to this area of concern is much less than it used to be.

Senator MACK. I understand that.

Mr. COTTRELL. And all of these programs—some of them more successful than others—but let's don't just say, well there is one major answer to this problem because, in my limited experience, I would say that is a false view. You need many different kinds of tools in different communities because communities are not the same.

Mr. TANKER. Senator Mack, if I could just make one comment to that as well. That is, it's true that one program probably isn't the cure-all. However, as a coinsurer, and I know that people in coinsurance have had various views and HUD has had various views about the coinsurance program. But one undeniable fact is it did produce housing, and lots of it, over the last couple of years, 3 or 5 years, whatever, that it was a program at HUD. One suggestion we would have from Benton's standpoint and one probably not likely to endear me to colleagues at this table, would be to make it a true, equally shared coinsurance program, and that is to say have the developer share in some portion, say 5 percent, of any project loss. Right now, it's a nonrecourse loan. They may have personal recourse to the syndicator, but we feel that if a developer was tied into a project like that, with some personal stake, that would assure continued vigilance, most importantly for the wellbeing of the tenants.

The other comment that I would have too, and this deals more with a broader social policy but one I think is absolutely necessary to deal with, is that we need to tie this coinsurance and housing program into some other policy considerations.

One of the major problems that we find in projects that we finance all across the country is drugs. And you've got to have some tie-in between housing policy and drugs. I know the Secretary has made some inroads in that. But that is absolutely essential, because nothing can ruin a project faster than a drug problem. And the current Mod Rehab doesn't provide, I don't believe, for any allowance for security in the rents. It is something that is needed, and also drug education programs would be needed and maybe working with HUD you could do that.

The last suggestion we would have would be to have HUD, the developer, the coinsurer, and the Federal, State, local authorities work with innovative not-for-profits, like the Enterprise Foundation, in trying to develop job training programs and day care centers, things like that at these projects or in these areas, so that the people can get off Federal assistance. You know, you don't want to see the same people living in federally-assisted projects all their lives. Obviously that's not the best social purpose. We are available to help in any way on an ongoing basis to talk with you or with anybody about these kinds of ideas that we have.

Senator GRAHAM. We are going to stretch that 20 minutes to 30 minutes and we will adjourn at 1 o'clock.

There has been some disagreement expressed at the table as to the numbers that Mr. Ols has on his chart. I would like to encourage anyone who would like to submit to the committee in writing their recasting of his financial statements so we can have the benefit of everybody's opinion.

Let me ask one last question on rents and then I would like to ask some brief questions on tax credits and coinsurance.

Mr. Cottrell, when you enter into a contract for section 8 rental, are there ever times in which, because of unexpected subsequent developments which may have made the original rent contract either too high or too low, that you have renegotiated a different rental rate?

Mr. COTTRELL. Senator, are you speaking about the section 8 generally or Mod Rehab specifically?

Senator GRAHAM. Both.

Mr. COTTRELL. In the section 8 existing program, for the certificate program—not for vouchers, but for certificates—we are required to do a rent comparability study. Now, if we and the owner can't agree, then we don't agree and there are built in increases available to the owner once a year particularly for increases in taxes or utilities and that sort of thing.

On Mod Rehab, this is the only Mod Rehab we have ever done. We were not involved, contrary to some earlier statements, we were not involved in that rent determination process. We did do a comparability study, but we were not involved in the rent determination process. So I can't speak on Mod Rehab, because this is the only one we've done.

Senator GRAHAM. Do you recall what your rent comparability study indicated you thought the rent should have been in Sierra Pointe?

Mr. **Cottrell**. I don't remember the specific numbers, although we could probably dig that information out and make it available.

Senator **Graham**. Could you provide that later?

Mr. **Cottrell**. Yes.

[The following information was subsequently submitted for the record:]

HOUSING AUTHORITY
CLARK COUNTY, NEVADA

5064 EAST FLAMINGO ROAD • LAS VEGAS, NEVADA 89122-5335 • PHONE (702) 451-0045

DOROTHY J. KIDD, CHAIRMAN
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W.F. COTTRELL, EXECUTIVE DIRECTOR
BRYAN LOWE, LEGAL COUNSEL

March 9, 1990

Mr. Edward M. Malan
Senate Committee on Banking,
Housing & Urban Affairs
Room SD 534
Dirksen Senate Office Building
Washington, D.C. 20510

Re: HUD Mod Rehab Hearing

Dear Mr. Malan:

I am returning herewith the Transcript of Proceedings of the hearings on February 27 before the Subcommittee on Moderate Rehab/HUD Investigations, with minor corrections of grammatical errors, etc. as noted.

In Addition, Senator Graham had asked during the hearing (ref. page 121) about our rent comparability study at the time rents were being determined by the coinsurer, Benton Mortgage Company. Apparently I misstated when I referred to a "study." In checking our records I find that there was no formal study, inasmuch as we were not involved in the rent-determination process.

However, I know there were staff discussions on the subject and we felt that comparable market rents were considerably lower. In December of 1988 (approximately 15 months after rents were set) we indicated to the owner/developer that the rents then in place were approximately 130% to 136% of rents for comparable units in the general area.

I am sorry I can't give you further written documentation on this matter, but apparently it does not exist. I apologize for the statement which may have been misleading.

Very truly yours,

WF Cottrell

W. F. COTTRELL
Executive Director

cc: Director of Housing Management
Senate Subcommittee hearing file

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HOUSING AUTHORITY
CLARK COUNTY, NEVADA

5064 EAST FLAMINGO ROAD • LAS VEGAS, NEVADA 89122-5335 • PHONE (702) 451-8045

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BRYAN LOWE, LEGAL COUNSEL

June 1, 1990

Senator Bob Graham, Chairman
HUD/Mod Rehab Investigation
Subcommittee
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510-6074

Re: Supplemental Information

Dear Senator Graham:

This is in response to your letter of May 22 received on May 29, and is supplemental to our earlier response dated, March 9, 1990 which in turn related to the testimony presented to the Subcommittee on February 27.

As noted in the March 9 letter, I found that we did not have a formal survey regarding rent comparability for Sierra Pointe. However, we have pulled out some raw data on comparability (which was done at the same time as Sierra Pointe) on the regular Section 8 program, and I am enclosing a copy of a memo dated June 1, 1990 which contains that information.

This data shows that 2-bedroom apartments were renting for amounts ranging from a low of $375 to a high of $425 per month, while the base rents for Sierra Pointe were $450 per month. For 3-bedroom units, we had only two comparables, at $410 and $440 per month, while the Sierra Pointe base rents were $562.

We do not have a copy of the material presented by the GAO at the hearing, and we have nothing further to offer in regard to their presentation.

If we can be of further assistance, please let me know.

Very truly yours

W. F. Cottrell
Executive Director

encl: Letter of March 9, 1990
Memo of June 1, 1990

cc (w/encl): Director of Housing Management
Senate Subcommittee hearing file

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HOUSING AUTHORITY OF THE COUNTY OF CLARK

InterOffice Memo

Date: June 1, 1990

TO: W. F. Cottrell, Executive Director

FROM: Janice Cordrey, Director Of Housing Mngt.

SUBJECT: Sierra Pointe - Comparable Market Rents

This memo is in response to your request for comparable market rents for the area of Sierra Pointe Apartments, our 160 unit Moderate Rehabilitation Development, during the period prior to execution of the HAP Contract in 1987.

Apartments that would have been considered as comparables for rent reasonableness certification at that time are as follows:

TWO BEDROOMS	MONTHLY RENT
1485 Sombrero	$ 375.00
1439 Sombrero	395.00
3380 Athens	375.00
3361 Athens	375.00
1335 Serape Circle	425.00
THREE BEDROOMS	
1335 Serape Circle	$ 440.00
4259 S. Maryland Parkway	410.00

Sierra Pointe Apartments' Base Rents, as displayed in the exhibits to the HAP Contract dated August 13, 1987, were $450.00 per month for two bedrooms and $562.00 per month for three bedrooms.

If you need any additional information, please let me know.

ADMIN FORM 48 (Rev. 12/77)

Senator **Graham**. On coinsurance, Mr. Coe, Mr. Tanker, as you know, that program has recently been terminated in HUD. Do you have any suggestions beyond those that Mr. Tanker has just made as to whether this program should be resurrected and, if so, how it should be modified?

Mr. **Coe**. In the first place, I'd like to state that it's very interesting that the department had undergone negotiations—had a dialog going with MBA, Mortgage Bankers Association, and various coinsurers to attempt to modify the program by increasing the capital requirements and more stringent monitoring of the program. I think it came to the industry as a whole as a shock when—in fact there was even a meeting with the MBA a week or two before the announcement came out and they left that meeting thinking that they had reached a compromise which would allow the program to continue.

I think that HUD had already put in some much more stringent monitoring reviews which would have in effect cleared up at least some of the problems in the program, and they were working on requiring more capital for each coinsurer. That would have made a significant difference also. I think some of the problems in the industry have been caused by undercapitalized firms.

But I think the worst thing is that they really shut this program down without having any viable workout procedure in place. By HUD's own admission, 20 to 25 of the 30 lenders in the program do not have an ongoing concern. Their businesses will eventually fail because they have no way to do more business and to get their portfolio up to an actuarially sound size.

So they canceled this program without any way to take care of those people.

Mr. **Tanker**. And if I could add to that, we don't have to go into the mess that the RTC and the banks and the S&L's are in. Freddie Mac is also in the process of reorganizing so it is not at this time a viable lending source for multifamily apartments. Fannie Mae is a viable lending source, but it tends to favor or tends to want more higher quality projects.

So without an FHA coinsurance program, there really is no viable way of financing low income housing in either the private sector or the public sector and there has got to be some way in order for these low and moderate income projects to be financed. There are some not-for-profits that are working maybe a ten-unit here or a ten-unit there, but given the need—and you heard Mr. Cottrell just in Las Vegas alone the size of the waiting list—there needs to be some program to help with that and maybe coinsurance in a restructured format would be that vehicle.

Senator **Graham**. If you would like to supplement your comments with some specific recommendations of what that restructured program should be, we're going to be holding hearings shortly focusing specifically on the issue of coinsurance and we will go into that in more detail.

Mr. **Tanker**. We would like to do that. Thank you.

Senator **Graham**. The last questions I have are on the tax credit. You indicated, Mr. Queenan and Mr. Abrams, and the chronology of the project substantiates that, the tax credit was granted after the project was complete. Our notes are that the Sierra Pointe units were placed in service in August 1987. The low income tax credits were allocated in March 1988. Is that correct?

Mr. **Abrams**. I believe some were allocated in 1987 and some in 1988 and the allocation I think the State of Nevada made proposed allocations but didn't confirm them until a later date. So I believe we had an indication earlier than March 1988.

Mr. **Queenan**. We had approximately half of the tax credits for which we had applied in one phase and then subsequently in December of that year received the balance of the credits from the State agency.

Senator **Graham**. What State agency in Nevada is responsible for this?

Mr. **Queenan**. In Nevada, the Division of Housing within the Department of Commerce.

Senator **Graham**. You indicated, Mr. Queenan, that the financing of this transaction had been put together prior to the availability of these tax credits. So therefore would the project have gone forward whether the tax credits were available or not?

Mr. **Queenan**. I believe, speaking for myself and I believe for Mr. Abrams, yes, it would, sir.

Senator **Graham**. When you applied to the State agency for the tax credits, did they have access to the information as to the financing of the project?

Mr. **Queenan**. On a preliminary basis, Senator, yes. We submitted our application which we had in turn submitted to Benton Mortgage Co. as one of these exhibits.

Senator **Graham**. If the project was feasible without the tax credit if it was either complete or substantially complete before the tax credits were available and therefore applied for—what was your argument to the State agency that they should grant you tax credits?

Mr. **Queenan**. Senator, under the 221D.4 coinsurance program there is no developer's fee allowed within project mortgage proceeds. We were making owner equity contributions at that time and now. I believe we previously testified, Senator, that we had projected in our analysis a positive cash flow of $55,000 in the first year of operations. Our actual experience was that a negative $55,000. The net effect then was $110,000.

Senator **Graham**. My question is, if I were in an agency and a developer came to me and said here's a project that I concluded was a feasible project and I sustained that by proceeding to build it and now it is either complete or almost complete, and at this point I'm asking for an additional subsidy, what was your persuasive argument to cause them to grant that subsidy?

Mr. **Queenan**. Senator, we were serving then and now a public policy purpose which essentially was the provision of affordable housing. Again, we're leasing 160 units to low and very low income houses.

Senator **Graham**. But would you have done that whether you got the low income tax credits or not?

Mr. **Queenan**. I believe we would have, Senator.

Senator **Graham**. Would your rents have been any different whether you got the low income tax credits or not?

Mr. QUEENAN. Yes, they would have, Senator. They would have been considerably below, because the agency was vested with the responsibility for determining project feasibility. They would have been considerably below if we had not had low income housing tax credits.

Senator GRAHAM. Your rents would have been lower if you hadn't had the credits?

Mr. QUEENAN. That's correct, Senator.

Senator GRAHAM. The rents would have gone down?

Mr. QUEENAN. That's right.

Senator GRAHAM. In other words, if you did not get the approximately—I can't see the chart over there [attachment II]—several million dollars of tax credits, that your rents would have gone down?

Mr. QUEENAN. Senator, there were additional—I believe Mr. Ols has also testified that there were—or Mr. Abrams—there were additional costs that we incurred during the course of construction of the project, approximately $300,000 in change orders were not supported in the form of mortgage increase by the coinsurer lender and by HUD.

Senator GRAHAM. I'm still curious at that statement. I could understand if you were to say that if you didn't get the tax credits the rents would have gone up, but I can't understand how the failure to get the tax credits would have caused the rents to go down.

Mr. QUEENAN. What I should have said, Senator, is that we would have had to contribute additional equity if the rents had been lowered by HUD.

Senator GRAHAM. In a previous hearing, we had a developer from California testify that of the tax credit benefit that he received, approximately 95 percent of it was reflected in lower rents. That is, if he got $100 per unit per month as tax credit, he would reduce the rents by $95.

What was the relationship between the amount of tax credits which you received and the rentals charged?

Mr. QUEENAN. Senator, the rents that are charged at Sierra Point conform with the low income requirements established by the Division of Housing for the State of Nevada entirely.

Senator GRAHAM. I'm sorry. I can't see the charts from here.

Mr. OLS. It's in the attachments one and two of our statement, Senator.

Senator GRAHAM. Could you just tell me what was the amount of tax credits per unit?

Mr. OLS. It was $5.8 million in total.

Senator GRAHAM. Does that reflect $580,000 times 10 years?

Mr. OLS. Yes.

Senator GRAHAM. Then the discounted value the 45 percent of that $5.8 million is what you estimated they were sold for, is that correct?

Mr. OLS. Syndicated, yes.

Senator GRAHAM. So at $580,000 per year for 160 units, that would indicate that the tax credits per unit would be something in the range of $3,500 per unit. Is that correct math?

Mr. OLS. Yes, I think so.

Senator GRAHAM. Or almost $300 a month per unit?

Mr. Ols. Yes.

Senator Graham. If you were willing to rent these at $596 under the section 8 contract, which was consummated prior to the availability of the tax credits and you thought it was a transaction worthy of pursuing under those conditions, then subsequent to that you got $300 per month per unit in a tax credit, what impact would that have on the rents you charged?

Mr. Abrams. Mr. Chairman, as Mr. Queenan was alluding to, we had large cost overruns during——

Senator Graham. But what would you have done——

Mr. Abrams. We would have and we were in the process of applying for a rent increase to cover the cost overruns during rehabilitation due to latent defects. Those change orders had been approved by FHA and had been submitted to the housing authority and to the HUD office for a rent increase. When we realized what we were going to get in proceeds from the housing credits, we withdrew that request and absorbed I think it was $300,000 or $400,000. So there would have been some incremental increase in rents if we hadn't got the housing credits.

Senator Graham. But I guess my question is, was there any incremental reduction in the rents because you did get the housing credits?

Mr. Abrams. No, sir, there was not.

Senator Graham. Do you think that public policy should have been some reconsideration of what the appropriate rents were given the fact that they were already 40 to 50 percent above the comparables, and also that you now had a windfall of $300 a month in tax income per unit?

Mr. Abrams. Yes, if those figure are accurate.

Senator Graham. Mr. Cottrell, I asked you earlier about whether you ever reopened section 8 or Mod Rehab and I think you indicated you never had done Mod Rehab since this was the only project that you have had.

In light of this and subsequent to your entering into the $596 a month rental level development, that is the granting of income tax credits which approximated $300 per unit per month, do you think this would be an appropriate project in which to reopen the rents?

Mr. Cottrell. Well, we've been told by HUD that it is.

Senator Graham. And what have you done?

Mr. Cottrell. Well, we received the notice in the last week I believe from the Under Secretary saying that HUD was in the process of reviewing rents on all of these projects and whether they had originally approved the rents or not that they would be looking for redress on this very issue. And as an agency we have no problem with that whatsoever.

Senator Graham. When you say you don't have a problem with it, are you enthusiastic about the opportunity to do justice and fairness or are you passive, or what?

Mr. Cottrell. Well, that's a kind of olympian point of view, but we would certainly want to do what was right.

Senator Graham. If you had known—maybe I should ask this question to Benton Mortgage since they essentially were delegated responsibility for setting the rents—that there was going to be a tax credit that would equal approximately $300 per unit per month, would you have still felt that $596 was the appropriate rent?

Mr. COE. Well, HUD has never had in place any kind of mechanism to take into account syndication proceeds into the cost or loan amount on a project. Perhaps that's something you could address with HUD. They just have taken the position that they don't consider syndication proceeds as a source of funding for projects.

I'd also like to kind of disagree with Mr. Cottrell. If HUD goes about its intended process of cutting rents on however many hundred of these projects there are, if that is taken to an extreme, I think you're going to cause a tremendous problem because not only from our perspective and the FHA general insurance fund you're going to cause projects to go into default, but other projects as well that aren't insured would also potentially go into default and then you're going to have a displacement of low-income tenants for something that's already in place and is operating very well.

Mr. TANKER. If I could further address the syndication issue like with the tax credits, oftentimes there's a mechanical problem there. As Tom mentioned, HUD instructs us when we do our mortgage credit analysis to make sure the developers can close the project loan. We are not allowed to take into consideration the sorts of syndication proceeds.

Senator GRAHAM. Well, one thing that concerns me is Mr. Cottrell has indicated a great deal of ambiguity as to what the rules are relative to Mod Rehab and I think suggested that the regional office, the office that he seeks counsel with, also was confused as to some of the applications. But you don't seem to have any uncertainty.

What specifically are you relying on for the statement that you cannot take into account syndication proceeds in arriving at an appropriate rent level?

Mr. TANKER. Well, it's the mortgage insurance. I wholeheartedly agree there's a lot of confusion in the Mod Rehab Program and how that relates to mortgage insurance and that's probably the basis for all the confusion we're seeing over the program. We, on the other hand—I'd like to come back to our contention that we are not a party to the Mod Rehab contract. We set the processing rents and for the rents like for the syndication proceeds a lot of times the developer hasn't even reached a final syndication agreement at the time of closing. That comes down the road sometime.

Mr. COE. There's just no basis in any of the HUD handbooks to take that into account. There are no rules telling us that we can do that.

Senator GRAHAM. And logic and reason wouldn't indicate that it would be appropriate? It seems to me you have a fundamental dilemma here. You approach the question of rentals in Mod Rehab as a public utility, i.e. you add up all the costs and you arrive at a figure and then what's a reasonable profit on top of that figure and that's what you go with. Or you do what the phrase "fair market rental" seems to infer, and that is you go out in the marketplace and find out what people in an open market, supply and demand, no coerced buyer or seller, are actually negotiating rents on comparable units for.

It seems to me that what we've had described today is the former, the public utility approach. There's no other rationale for arriving at a $596 figure to support where the market is $425. But then, you don't take into account the most significant economic factor in that public utility, and that is a $300 per unit per month subsidy through the tax credit.

Mr. COE. Again, that wasn't in place at the time this project was developed. The legislation just wasn't there.

Senator GRAHAM. I know. The question that I asked you was, if you had known that it was available, would you have come in with $596? And you said you would have because you had no basis to take it into account. So is the answer still that had you known of this $300 a month benefit you would not have taken it into account?

Mr. COE. Given everything else equal, we probably would not because HUD doesn't allow us to do anything else. That's the way the coinsurance program works.

Senator GRAHAM. You have taken on a lot of the alter ego of the agency. You set the rents. You make a lot of management determinations. Do you also advise your HUD copartner in this when you believe that there are policies that are either erroneous or policies that are pleading to be made? If so, has the question of incorporating the value of the tax credits in arriving at the rent structure been one of those areas that you've gone to HUD about?

Mr. COE. Well, we always sought guidelines or guidance from HUD any time there was a question.

Senator GRAHAM. I'm asking you, proactively, do you ever recommend any changes to HUD?

Mr. COE. We tried. HUD did not want to talk to us after some of the audits started to be released about the various programs, but we have numerous letters we've written to HUD and to you, Senator, as well about some of the problems we saw in the business.

Mr. TANKER. And if I may just add, with the HUD partnership, as Tom said, we've always tried to work with HUD and they are our partners—80 percent/20 percent—however, you might be amazed to know that when we would go to HUD to get rent information or expense information comparables in various areas we were told we couldn't get that information from HUD unless we submitted a Freedom of Information Act request.

It was our idea to set up some kind of electronic data base across the country because we're not everywhere—HUD is—and we could maybe share some data. But they said that they would not share that data. And not only that, but that the supervisor in the coinsurance department told me that were we to go in with our appraiser, as we had hoped to do in one of the field offices, to get information about rent levels and expenses, the HUD employee who talked to us could get "demerits" for talking with a coinsurer. That shows what we've been up against with this. We would love to give them policy suggestions, as Tom said. We have. But, unfortunately, we're a little company from Knoxville and not really in their scope of policy direction.

Senator GRAHAM. Gentlemen, thank you very much. This has been an extremely instructive panel this morning. We will reconvene with panel three at 2:30. Thank you.

[Whereupon, at 1:20 p.m., the hearing was recessed, to be reconvened this same date at 2:30 p.m.]

[AFTERNOON SESSION]

Senator **Graham**. I call the meeting to order. I appreciate your indulgence with our unpredictable schedule. I would like to introduce the third panel, made up of various individuals who will bring a particular perspective on the issues which we have discussed and the specifics of the first two panels. I will briefly introduce each of the members of the panel and then, call upon you to make whatever comments you would like in the order that you are recognized. We will turn to questions.

Ms. Melkonian.

STATEMENT OF MARILYN MELKONIAN, PRESIDENT, TELESIS CORP., WASHINGTON, DC

Ms. **Melkonian**. Thank you, Senator. My name is Marilyn Melkonian. I am president of the Telesis Corp., which is a Washington, DC based firm that is involved in community development and the development of affordable housing.

I am working in a particular neighborhood carrying out both rehab and new construction of about a thousand units in conjunction with tenant organizations and nonprofits as well as private investors and the local and Federal Government.

I want to thank the committee for its invitation to appear here today and I want to commend the committee for the constructive approach and the positive approach it is taking in its hearings this year in examining the role of the Department of Housing and Urban Development, the role of private participants; and, the direction of public policy in addressing the housing needs of the American people.

In sorting through the complex issues and activities that make up housing policy, it is sometimes easy to lose sight of the common ground. The belief that all Americans have a right to decent, affordable housing and suitable living environments, a promise that we enacted into law over 40 years ago. We are, hopefully, entering a new era of commitment in delivering on that promise.

However, in examining the questions being raised by the committee today, I think it's important to keep in mind where we are.

At this time, there are no housing production programs at the Federal level. The public/private partnerships to produce affordable housing exist only at the State and local level. It is at the State and local levels that the patchwork of public and private investment is assembled to build and rehabilitate housing affordable to lower-income Americans.

The question of appropriate levels of compensation, return, investment, risk and ownership of residual value are wrestled with there.

Pat Clancy in his testimony has ably described the many factors that weigh in making the judgments that provide an adequate but not excessive return to developers.

I would like to associate myself with those remarks. He correctly highlights the elements that go into an incentive system for developers—coverage of the cost of doing the project, reserves for contingencies and a return that is sufficient relative to other competing activities.

This last element will vary with the degree of difficulty of the project, competition among developers and local market conditions.

I especially want to associate myself with his hope that your consideration of this issue will leave you with an understanding of the difficulty of establishing unchanging objective criteria for the appropriate level of incentive and return for affordable housing production.

I would like to highlight for a moment the role of the Federal Government in the public/private partnership for affordable housing.

This partnership, as you know, goes back over half a century. And the reason that we entered into it was the devastation that we saw in the Great Depression, the fact that, at that time, two-thirds of all Americans were renters; one-third of the Nation was ill-housed—remember the famous statement in the inaugural address of Franklin Delano Roosevelt, and the Federal Government's response was to intervene in the private market. And it did so in an amazingly creative and imaginative way with the creation of the Federal Housing Administration and the introduction of Federal guarantees and incentives into the private mortgage market, which created for the first time long-term lending for homes.

That resulted, within a generation, in turning around the ratio between homeowners and renters. We became a nation of homeowners and ultimately have experienced prosperity and the creation of a middle class based on homeownership.

Homes are the only capital asset that are broadly based in ownership. All nonresidential assets are concentrated in the top 2 percent of American households. Homes are really the wealth of our Nation and the opportunity to create a homeownership market was really invented by the genius of the mixed economy and the partnership between a Government and private industry.

At the same time, 50 years ago, we recognized that Americans of lower incomes did not have access to the private housing market. And the response to that—the first response to that—was the creation of the public housing program, which was thought of as housing of last resort.

Capital costs of the housing were completely paid for, residents paid the operating expenses, and the housing was thought of as transitory, something, that after you climbed the economic ladder, you would leave behind.

But, from 1937, which was the beginning of the Public Housing Program, the first time access to housing for very low-income Americans, the gap between housing costs and incomes of low-income Americans widened and continued to widen through 1961, when we entered into an entirely new approach. We changed direction from investment in public housing to an investment in a public/private partnership.

And under the early programs, which were direct loan programs, interest write-down programs, we created a relationship between the Federal Government and the private sector to produce, develop, build housing for Americans whose incomes exceeded the income levels for public housing.

And so that housing gap for people whose incomes were too high for public housing but too low to access the private market was meant to be filled by public investment in partnership with private owners and owners who would build and own that housing and reduce costs to the residents.

That was accomplished. Over the last 25 years, we have built 2 million units of housing under a variety of Federal programs that are now in private ownership. That partnership exists today.

We have the responsibility at the Federal level for managing, monitoring, assisting over two million units of housing. We're not building housing any more, but we have the responsibilities to preserve a vast stock of housing that was created in the past.

One of the questions that was debated this morning was the question of certificates versus supply. The existing Federal stock represents over 20 percent of the supply of housing that is affordable to Americans earning below $15,000 a year. And one out of every three households in this country earns below $15,000 a year.

One out of every five American households earns below $10,000 a year. And families earning below $10,000 a year, the majority of them are paying 50–60 percent of their incomes for housing.

That is the dimension of the housing crisis we have. It affects roughly 8 million households. That is the gap, the housing gap that exists today.

Now, there are two basic ways to address that gap. We can either increase incomes so that people have access to the private markets' housing supply, which is basically the certificate program and the voucher program. And that works, and it provides people with freedom of choice. It's easy to administer and it has wide applicability.

It would be a perfectly fine program to pursue if we were willing to pay the cost of it. In other words, if we were really willing to subsidize income sufficiently so that all individuals who need additional income to access the private housing market would be entitled to that subsidy.

The cost of that is probably politically prohibitive. As a member of the National Housing Task Force, we estimated that the cost of that program, an entitlement program which would only reach about half of those people earning below 50 percent of median income, would be roughly $17 billion.

The other way to approach this housing gap is to look at the supply side and to say:

How can we produce a permanent supply of affordable housing that will, over time, relative to the cost of the housing in the private market, remain low and, therefore, decrease the need for subsidies in the future? Because, if we choose the route of only supplementing incomes, we are choosing spending, let's say, if we want to really do it and not just talk about it, $17 billion a year, year in and year out, with increasing costs as the price of market housing increases. And we will not own anything in the end.

We will not have a permanent supply in the end. We will be renters, in effect, and not owners.

If we compare that cost to what we accomplished in producing the supply we did produce, the per unit cost of the subsidies in connection with that stock are significantly less than the per unit cost of certificates.

Certificates are running approximately $5,000 per unit and the average subsidy cost of the housing that was built in the past is approximately $3,000 a unit annually.

So I'm not advocating one approach or another. I'm advocating a mixed approach. Certificates, vouchers and income supplements are good things and they work. And in certain markets, they don't work.

And we have to pursue a policy of adding to the supply as well, both for the reason I stated—I think it's cheaper in the long run to do that, but also because housing is parts of neighborhoods and we can't abandon the production and rehabilitation aspects of housing without abandoning neighborhoods and communities.

We spend very, very little money on housing relative to our national budget. Our total expenditure is roughly $13 billion a year to stay exactly where we are—about 1 percent of the Federal budget.

Since the beginning of time, we have spent far less on housing than we spend in 1 year's interest on the national debt. So, our ability to commit, over time, resources to this important area is great. The need in dollars is relatively small to be able to accomplish in the long-run what we set out to do more than a half century ago.

And that was to provide a decent home and suitable living environment for every American.

Thank you.

[The complete prepared statement of Marilyn Melkonian follows:]

STATEMENT
OF
MARILYN MELKONIAN
PRESIDENT, TELESIS CORPORATION

BEFORE THE

HUD/MOD REHABILITATION INVESTIGATION SUBCOMMITTEE
OF THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
OF THE
UNITED STATES SENATE

FEBRUARY 27, 1990

Mr. Chairman, members of the Committee, I want to thank you for your invitation to appear here today. I also want to commend the Committee for the constructive and positive approach it is taking in its hearings this year in examining the role of the Department of Housing and Urban Development, the role of private participants and the direction of public policy in addressing the housing needs of the American people. In sorting through the complex issues and activities that make up housing policy, it is sometimes easy to lose sight of the common ground - the belief that all Americans have a right to decent, affordable housing in "suitable living environments" -- a promise that was enacted into law over forty years ago with broad bipartisan support.

In order to address the question of the current status of the "public-private" partnership that has developed over the years to meet these needs and fulfill this promise, it may be useful to review briefly where we have come from and what has been accomplished.

Housing Policy - A Brief Retrospective

More than a half century ago, the government intervened in the private market in response to the economic devastation of the Great Depression, with an understanding that housing was an essential ingredient for national recovery and prosperity. The New Deal created the Federal Housing Administration which provided government guarantees for long term lending of private capital for home mortgages. In the 1930's less than one-third of American households owned homes. Federal mortgage guarantees and other incentives revolutionized the capital markets for housing. Within a generation, America became a nation of homeowners, reversing the ratio of renters to homeowners, with almost two-thirds of its households owning their own homes.

No other single public policy did more to create the American middle class and the wealth it enjoys. Homes are the only significant capital assets which have a broadly based ownership. Nearly all of the nation's non-residential assets are owned by the top 5% of all households and concentrated in the top 2%.

This was accomplished at no cost to the federal government. To this day, the Mutual Mortgage Insurance Fund, paid for entirely by homebuyer mortgage insurance premiums, is in the black.

While the major thrust of national housing policy from the thirties through the fifties was the expansion of mortgage credit and the creation of homeownership opportunities, federal policy recognized that Americans with very low incomes could not afford to participate in the private housing market. The first response to this need was the construction of publicly owned housing. Public housing was originally conceived as a way station for families who would climb the economic ladder and leave it behind for others in transitory need.

By the early sixties, it was becoming clear that the "housing cost gap" was widening. People above the income limits for public housing had incomes still too low to access decent, affordable housing in the private market. The federal response to this "housing gap" was a major change in the direction of national housing policy. A "public-private" partnership was created. The federal government assisted the private sector, both for-profit and non-profit, to build housing to fill this "gap." A variety of techniques were used. The first programs for the elderly and families involved direct low-interest loans. Later, spurred by the cataclysm in our urban areas in the late 1960's, housing programs in the 1970's used mortgage interest write-downs on loans made by the private sector; rental subsidies to low income tenants, and preferential tax treatment to owners and investors.

Today, as a result of these policies, approximately 5% of the nation's housing supply, about 4.4 million units, is federally assisted. This includes approximately 800,000 units of private housing occupied by tenants receiving rental assistance (certificates and vouchers); about 2.2 million units created with federal subsidies in private ownership (221(d)(3); 236; Section 8 new construction, substantial and moderate rehabilitation); and about 1.4 million units of housing in public ownership.

If future federal commitments were to end today, this substantial legacy of national housing policy remains. It costs approximately $13 billion a year to maintain these commitments, about 1% of the federal budget. It represents about 25% of the housing stock affordable to people earning less than $10,000 per year (one out of every five American households). It is the departure point for where we go from here.

Reversal of the National Commitment to Housing

Beginning in 1981, national housing policy was radically reversed. The four decade, bipartisan consensus that the federal government has a role as a leader and investor in assuring and creating affordable housing opportunities for Americans was overridden by an Administration that believed the opposite. The belief that "government is the problem and not the solution" was acted on with a vengeance in the administration of housing policy. Federal funding commitments to housing were slashed by over 60%, reduced basically to a maintenance budget which is where we are today; annual additions to the supply of federally assisted housing fell by about two-thirds, over 200,000 units; HUD staff was cut by over 20% and a rhetoric of denial toward housing and urban needs was the order of the day.

The aftermath of this radical reversal in housing policy has been a highly publicized focus on how the scrapes of the remaining housing programs were maladministered.

The free-fall of housing policy through the eighties is now at an end and in this, as in many other areas, we are faced with choices and responsibilities. How do we administer current federal housing commitments and how do we assure that the pressing and increasing housing needs of a broad spectrum of Americans are met in the coming decade? We now have an opportunity to redefine the federal role and commitment to creating affordable housing opportunities.

Preserving What We Have

In my view, the departure point for addressing the federal role in the public-private housing partnership is to look at the existing responsibility for the stock of federally assisted housing. Virtually all federal spending through the Department of Housing and Urban Development goes to maintain current financial commitments to the federally assisted housing described earlier, approximately 4.4 million units. HUD is no longer in the business of producing housing. It does, however, have enormous preservation responsibilities.

Over 2 million units of housing were developed in a public-private partnership over the last twenty-five years using a variety of mortgage insurance programs and subsidies. This stock is regulated by HUD and is privately owned. The portfolio value of this housing exceeds $40 billion and its replacement cost would be well in excess of $100 billion. Whether or not HUD is directly involved in future housing production, it requires today the capacity, skill and resources necessary to carry-out its end of the public-private partnership that developed this housing. This is a responsibility it has now. The administration of the Department over the last decade largely stripped the Department of its capacity to perform its responsibilities to oversee and preserve the housing stock developed with federal investment. I believe that this capacity needs to be re-built and a new commitment made to carrying out this responsibility.

It is in the preservation context that the federal government will be addressing directly the issues being raised by the Committee today: the status of the public-private partnership; the question of risk and return; how much subsidy is the appropriate amount to invest? HUD will face these issues, not in the production of affordable housing, because there are no production programs at the federal level, but in the preservation of housing it insures and subsidizes and in the disposition of housing that it owns. These issues are also confronted by state and local agencies which invest public funds to produce affordable housing, including the allocation of low income housing tax credits.

The Public-Private Partnership for Affordable Housing - Why Do We Need It?

Defining the public-private partnership for housing is especially important if you believe that meeting the housing needs of the American people will require direct public investment in a supply of affordable housing. In my view, an effective national housing policy must address a range of issues that impact on the availability of affordable housing opportunities, most significantly, tax and monetary issues. The level of interest rates, for example, is probably the single most important factor affecting the affordability of housing, especially access to homeownership. Lower interest rates, in and of themselves, would permit the private market to provide more affordable housing.

However, at low income levels, especially below $15,000 per year of household income (which is one out of every three American households) the cost of housing must be below $375 per month to be affordable (using 30% of income for housing cost). It is the market supply of housing at and below this price range that has been shrinking for the past two decades for a variety of reasons: demolition, rising costs for maintenance and operation, and for the last decade, reductions in public investment. There is no market dynamic that will reserve this trend in the contraction of the supply of low cost housing. Neither is there a market dynamic that will cause significant increases in household incomes to meet higher housing costs. Without public investment, the private market is simply not able to produce and maintain housing that costs less than $375 per month although the demand for such housing is great.

This "housing cost gap," is the source of the housing crisis we face today. There are only two basic ways in which it can be addressed: incomes can be raised, or the cost of housing can be reduced. The housing certificate and voucher programs essentially address the income side by providing additional income to people to pay the cost of housing that exists in the private market. The advantages of these programs is that they provide freedom of choice to people; they are relatively easy to administer; and, because of the enormous need, additional assistance can be put in place quickly, using up any additional funding for housing that would be appropriated in the foreseeable future.

The disadvantage is that, in many markets, current per unit subsidy levels are not high enough to pay the cost of available housing and the voucher and certificate programs can not be used. There is no question that income supplements will work if they are high enough. They will permit access to the existing stock and they will trigger production if they are high enough. The cost of this approach, however, is politically unacceptable. The estimate of the National Housing Task Force of the cost of an income support program if used by only half the households below 50% of median which would be eligible for the program, at the existing fair market rent levels, was $17 billion annually.

The other basic approach is to address the cost of the supply. This has been approached in a variety of ways: interest write-downs; construction grants; operating subsidies to both public and private owners. The advantage to this approach, if the programs are properly designed, is that the investment can create a stock of permanently affordable housing. Once the capital costs are paid off, rents and public subsidies are used to pay maintenance and operating costs and a return to the housing provider. Over time, the cost of this housing, relative to other housing in the private market, remains low. The disadvantage, based on past experience, is that programs to add to the supply have not been properly designed. In the case of public housing, although largely successful in many communities, it has produced monstrous anti-human failures in some. In the case of the housing produced in the public-private partnership with HUD over the last twenty-five years, while largely a success in creating an affordable housing supply of over 2 million units, the supply is not permanent. As projects approach their twentieth anniversary, use restrictions are expiring and additional federal investment will have to be made to keep private owners in the programs.

The simple fact is that if we are not going to supplement incomes to the extent necessary to permit the private housing market to meet all housing needs, then an element of our national housing policy must be well-designed and well-implemented programs to add to and preserve the supply of affordable housing. This means providing public investment to private, public and community organizations which develop, build, own and manage affordable housing.

If we recognize that a permanent part of our housing market place is going to involve private organizations using public investment to provide affordable housing, then we need a set of principles and a clear understanding of rights and responsibilities that will govern the relationship between the public investor and the private user of public funds.

The evolution of the public-private partnership between HUD and private owners, both for-profit and non-profit, over the last twenty-five years holds many lessons. Many lessons can be learned at the state and local level as well.

Defining the Public-Private Partnership - What It Was

The public-private partnership to create affordable housing began at the federal level in 1959 with the enactment of a direct loan program for non-profits to build housing for the elderly, the Section 202 program. In 1961, a direct loan program was enacted to build housing for families, as well as the elderly, which was open to for-profits and non-profits alike, the Section 221(d)(3) program. Subsequent development programs subsidized interest rates and rents, the Section 236 and rent supplement programs. In 1974, the Section 8 program combined financing and rental subsidies.

The common elements of the public-private partnership in these programs were: limitations on project cash flow payable to owners; limitations on fees payable to developers, builders and other consultants from mortgage proceeds; high loan to cost ratios (for non-profits, 100% financing); rent regulation and monitoring by HUD; targeting to certain income levels and use restrictions, including prohibitions against mortgage prepayment and termination of regulatory agreements. Tax benefits available to owners were not factored into project sources or included in HUD underwriting. However, owners were responsible for cost overruns and operating deficits, although HUD recognized certain additional costs at the completion of construction and final endorsement of project mortgage insurance.

Measured against the three traditional sources of return to developers and owners of real estate, developers of low and moderate income housing were limited in two areas. That is, project cash flows were restricted and use restrictions limited project appreciation. The third area, tax benefits, were governed by laws affecting the tax treatment of low and moderate income housing, or real estate generally, and were not regulated by HUD.

Future Directions in the Public Private Housing Partnership

HR. 1 passed at the end of last year requires that the Secretary of HUD "certify that assistance within the jurisdiction of the Department to any housing project shall not be more than is necessary to provide affordable housing after taking into account" all other public assistance.

This introduces an entirely new approach in the relationship between private owners and HUD in determining what the amount of public investment in a project should be. For the first time HUD will be required to look at returns to the developer/owner from all sources, including tax benefits, in determining what amount of public investment is appropriate.

This approach will necessarily require a better analysis and understanding of how risk and reward is to be shared and allocated between and among the the public and private partners.

Some questions are: who will bear the risk of cost overruns or operating deficits or changed circumstances? What do we want private owners to do? Do we want to limit the owner's opportunity for realizing appreciation of the value of the housing in order to serve the objective of creating a supply of affordable housing for the long term? If we do that, how do we want to treat project cash flow as a source of return for ownership and management of the housing over the long term? Can we develop a new breed of housing developers, owners and managers who will be attracted to these tasks without the traditional compensations of real estate development or even the traditional compensations of low and moderate income housing development?

Restoring HUD As A Full Partner

I will offer a few observations in the context of the current reality of public investment in affordable housing. First, as stated earlier, at the federal level there are no production programs and there are not likely to be any in the next few years, at least. HUD's current responsibility is to administer, monitor and assist the more than two million units of affordable housing in private ownership that were developed under a variety of programs over the last quarter century. It is also HUD's current responsibility to monitor and assist public agencies which own 1.4 million units of public housing throughout the country. This means that HUD, as an organization, must be restored as a full functioning and cooperating partner to private, for-profit, non-profit, and public owners of affordable housing. It must be given the resources to properly perform this role, both in staffing and investment dollars. The direction of the last decade must be reversed. If this does not happen, the questions being raised by this Committee are intellectually interesting in relation to HUD, but irrelevant. We will continue to witness the decline in the federally assisted housing stock and the loss of this important investment.

HUD Must Act

Secondly, in carrying out its preservation responsibilities, which means dealing with issues of prepayment of project mortgages under the 1987 Emergency Low Income Housing Preservation Act; addressing the needs of troubled projects; or selling properties that it owns, HUD will, by virtue of doing these things be re-defining its relationship with private owners, both for-profit and non-profit and its partnership with state and city agencies. There are no magic formulas for providing the certification which HR 1 now requires the Secretary of HUD to make. Each project will present a different set of circumstances and a different set of needs. And these projects are already subject to pre-existing economic and legal relationships which will have to be taken into consideration.

HUD should be encouraged to go forward and make these decisions and judgments. A failure to make a decision in the preservation area is itself a decision. There should be an understanding between the relevant Committees of the Congress and HUD that HUD is expected to go forward on the many pending cases it has before it while it is attempting to develop standards and procedures pursuant to HR 1. The new Administration at HUD will be far better informed and able to rebuild the public-private partnership if it is given room to act on its responsibilities and to test current thinking in the context of action. It would be ironic if the final legacy of the last administration was to cripple the confidence of the new administration in dealing with the major professional responsibilities of the Department. HUD should be permitted the breathing room to act on its responsibilities without fear of criticism.

Partnerships For Affordable Housing Production At The State And Local Levels

Third, new affordable housing production and development, to the extent that it is taking place, is happening at the state and local levels using local resources, low income housing tax credits, tax exempt bond financing, and federal resources made available at the local level such as Community Development Block Grant Funds. The process of developing affordable housing today, as anyone who is trying to do it knows, is long and frustrating because of the need to patch together so many different sources of financing. Since the end of federal production programs, affordable housing production responsibilities have fallen to the states and local governments and they are properly deciding what allocations of risk and reward; compensation; control of appreciation, is appropriate. The development of affordable housing in the years of federal disinvestment has attracted a new breed of housing provider at the state and local level. The new breed is committed to the entrepreneurial tasks of housing such as developing, building, managing, rather than seeking compensation through long term appreciation of the housing. If this direction were to be pursued and encouraged, then public investment could be geared to creating a permanent supply of affordable housing developed, built and managed by both public and private housing professionals.

New Housing Entrepreneurs

Lastly, the concept of "the housing professional" as the partner in using public funds is the concept of an organization which provides a variety of housing services and is compensated for doing them well. But, reorganizing the economic incentives to a housing provider, does not mean that housing will be less costly to produce. It will not. The cost of housing will depend on the cost of land, the cost of construction, the cost of financing, taxes, insurance and the multiple other costs that go into housing production. The cost of the public subsidy will depend on the income levels targeted to be served. The lower the incomes, the greater the subsidy. Compensation to the housing professional will have to be sufficient to keep such organizations in business and attract new ones. The level of compensation should not be different whether the organization is a for-profit or a non-profit.

In fact, I believe that we should encourage a new form of corporation to do business in this area that would eliminate the distinctions between for-profit and non-profit organizations. An organization that uses public investment to meet certain defined affordable housing needs should be permitted to accumulate capital within the corporation free of taxation or at least free of taxation up to a certain level. This would permit housing providers to acquire capital reserves and to build equity in their organizations which would be available for new investment. We need to build new organizations and create new incentives to serve that part of the housing market which will not be served without public investment. We need to encourage the new breed of housing providers and create a permanent role for them in our mixed market housing economy. The standards for judging success in this area are no different from judging the success of housing development anywhere: The housing must work and it must look good; it must satisfy the people who live there; and it must make money. Whether public, private or mixed investment, these standards apply.

A final comment on the federal role. Direct and indirect investment by the federal government in housing involves, and will continue to involve state, local, private and public partners. For forty years, the federal government provided leadership, creativity and investment. It is not doing that today. The problem of affordable housing is at a critical level and growing. If we are to meet this basic need, we must examine how to adjust our housing finance system to permit the private market to serve a greater spectrum of housing demand; we must be unequivocal about the need for federal investment and leadership and provide it; and, we must act now to rebuild and support the agency charged with these responsibilities. The stone is at the bottom of the hill.

PAYMENT TO COST VARIABLES AND ANALYSIS SHEET

		1ST RUN	LATEST	DIFFERENCE
#1	Annual Income	$15,000		
#4	Vacancy %	0.03		
#6	Cost of Operations	$3,000		
#7	Other Debt	$0		
#8	Cost of Other Debt	$0		
10	Rate of return on equity	0.1075		
13a	Constant	0.112017764		
13	Coverage	0.90		
14	Term	30		
15	Interest Rate	0.1075		
22	Other Equity	$0		
24	Profit/Fee as a % of Dev. Cos	0.10		
26	Relocation	$0		
28	Interim Cost of Operations	$0		
29	Commission	$0		
30	Marketing	$0		
31	Legal	$500		
32	Title and Recording	$500		
33	Financing Fees as % of Dvlp C	0.04		
35	Insurance	$200		
36	Taxes	$500		
38	Constr. Time/Months	12		
39	Constr. Interest Rate	0.11		
40	Architect Supervision %	0.03		
41	Architect Design %	0.04		
43	Constr. Contingency %	0.05		
#45	Construction Cost	$45,000		

	BALANCE NEEDED FOR CONSTRUCTION	AVAIL. FOR ACQUISITION
1ST RUN	$42,224	$0
DIFFERENCE	$0	
LATEST	$42,224	$0

ASSUMPTIONS :

- Job is for one 2-BR unit of 900 sq. ft. It is mid-range quality and is garden style.
- The job is one of either substantial rehab or new construction.
- For the purposes of calculating construction time, assume 50 units.

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PAYMENT TO COST FORM

DEVELOPMENT COSTS

#47 AVAILABLE FOR ACQUISITION		$0
#46 BLNC NEEDED FOR CNSTRCTN		$42,224
#45 CONSTRUCTION COST	$45,000	
#44 CONSTRUCTION CONTINGENCY		$2,250
#43 CONSTR. CONTINGENCY %	0.05	
#42 TOTAL ARCHITECT FEES		$3,150
#41 ARCHITECT DESIGN %	0.04	
#40 ARCHITECT SUPERVISION %	0.03	
#39 Constr. Interest Rate	0.11	
#38 Constr. Time/Months	12	
SOFT COSTS		
#37 Construction Interest		$603
#36 Taxes		$500
#35 Insurance		$200
#34 Financing fees		$487
#33 Financing Fees as % of Dvlp	0.04	
#32 Title and Recording		$500
#31 Legal		$500
#30 Marketing		$0
#29 Commission		$0
#28 Interim Cost of Operations		$0
#27 SOFT COST TOTAL		$2,791
#26 RELOCATION		$0
#25 PROFIT/FEE		$1,219
#24 PROFIT/FEE as a % of DEV C	0.10	
#23 TOTAL AVAILABLE FOR DEVELOPMENT		$12,186
#22 OTHER EQUITY		$0
#21 EQUITY ONE		$1,219
#20 PERMANENT DEBT AVAILABLE		$10,967
#19 OTHER EQUITY as % of DEV CST		0.00
#18 EQUITY ONE % as % of DEV CST		0.10
#17 DEBT AS A % OF DEVEL. COST		0.90

PAYMENT CALCULATION

#16 PERMANENT LOAN		$10,967
#15 INTEREST RATE	0.11	
#14 TERM	30	
#13 COVERAGE	0.90	
#13a ANNUAL CONSTANT	0.112017764	
#12 AMOUNT AVAIL. TO SERVICE OR NET EFFECTIVE INCOME		$1,229
#11 CASH FLOW (1ST RETURN ON EQUITY)		$137
#10 RATE OF RETURN ON TOTAL EQUITY	0.11	
#9 NET INCOME		$1,365
#8 COST OF OTHER DEBT		$0
#7 OTHER DEBT	$0	
#6 COST OF OPERATIONS		$3,000
#5 VACANCY COST		$135
#4 VACANCY %	0.03	
#3 TOTAL ANNUAL HOUSING PAYMENT (*)		$4,500
#2 MONTHLY HOUSING PAYMENT (*)		$375
#1 ANNUAL INCOME		$15,000

(*) - Excluding Utilities

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Senator **Graham**. Thank you very much, Ms. Melkonian.

Ms. Kollias.

STATEMENT OF KAREN KOLLIAS, VICE PRESIDENT OF COMMUNITY DEVELOPMENT LENDING GROUP, AMERICAN SECURITY BANK, WASHINGTON, DC

Ms. **Kollias**. Good afternoon. Thank you for inviting me here. I am Karen Kollias, vice president and manager of the Community Development Lending Group at American Security Bank, which is a bank located in Washington, DC.

One of the things that I wanted to do was give just a very brief background in terms of why I think that I was asked to be here. And that is I represent a lending institution which has as a basic form of business providing financing, primary financing for low and moderate income housing. We lend to projects as well as to developers, such as Marilyn Melkonian, in the District of Columbia and to the areas in the metropolitan area.

Over the past few years, we have been responsible for financing over 6,000 units of low and moderate income rental housing, as well as several hundred units of low income ownership, primarily through the forms of limited equity coops.

We represent a trend that I think we've been seeing over the past several years across the country where private lenders have been, for one reason or another, been getting more and more involved in community development lending, particularly in the financing and structuring of affordable housing projects.

Some of those also had to happen and it's happened simultaneously with the reduction of Federal and, therefore, local public resources that have traditionally been available, again, either in the form of subordinated debt, equity subsidies and so forth, those types of sources that people have been able to look for with making these projects feasible.

What that's done is it's made the project sector, the lending community, in particular, having to get very smart about how to continue to structure and get creative about making as many dollars possible for these kinds of projects.

And so to talk a little bit about how that works and not moving forward any type of national policies or budget recommendations can take into consideration some of the experiences that the private lenders have been able to have over the past several years.

First of all, I think it's important to know, as Marilyn had mentioned, that we are moving into a whole new, more sophisticated industry of affordable housing. We have more sophisticated lenders represented through the private sector, as well as a range of different developers which are represented at this table today.

Together we form the very important part and the most financially available part of any type of public/private partnerships. We have unlimited resources, while on the public side, we have very, very limited resources.

So we've got to figure out a way that we can pull these two different things together to the extent that we can get direction on the public side in terms of what our priorities, in terms of community benefit.

We can help assist the public sector in terms of making sure that we understand and underwrite correctly those projects so that they stay economically viable.

I think that's where the issue of the subsidies come in and how that works.

From a private sector standpoint, a lender is going to underwrite a project based on cash flow coming in from the project. And in that situation they are going to be only able to lend as much as the cash flow will allow, plus some coverage if you use long-term investments standards, particularly those that are used by Freddie Mac and Fannie Mae.

To that extent, that's going to basically back the lender into what is the loan amount that they can provide to a project; then it also still has to be within acceptable loan to value ratio requirements, especially given our regulatory requirements that we have to adhere to.

Basically, what we see, especially with affordable housing, is that there will be undoubtedly a gap between the amount that a lender can invest in these projects and what the total development costs are; because the development costs are not as significantly different between a market rate rental project or a low income rental project.

In the past, it used to be that, especially in certain neighborhoods, you might be able to get affordable housing projects. You could pick them up vacant, boarded up projects at a lower amount of money per unit. But we are seeing that even that is changing rapidly.

And the basic costs of free development in terms of rehab, gut rehab, replacement of systems, and so forth, is basically the same.

So you are going to have a development gap there. That's really where the role of the public sector needs to come in.

As Marilyn had mentioned, there's two different ways to fill those gaps. If there's income that's supplemented by long-term subsidies in the form of certificates and the projects are underwritten that way—although we advised the private sector not to do that because those certificates could go away—but, in the event that you have a supplemental income, you can have a higher loan amount, so you're dealing with a subsidy over a long period of time.

On the other hand, if you want to have a short-term subsidy, a one-time hit, then you do need the type of resources on the front end, which have been traditionally available through the rental Rehab Programs or the community development block grant programs, where you have almost in effect an interest rate going into the project that gets repaid over a period of time.

I think, in any event, what we're seeing in terms of trends in the development of affordable housing and the preservation of affordable housing, we are going to need very strong and clear policies. They're strong but they also are supportive of locally based initiatives.

To the extent that you can have them coming out of a lot of private sector initiatives where you've got a sponsorship that's very strong in the private sector that's underwriting both the project from its economic viability standpoint as well as the developer, the public sources will be much better utilized.

I think that one of the problems, and I know one of the issues that you want to address with these hearings is the issue of what's an appropriate amount of subsidy. What is the rate of return for developers given some of the other projects, and some fundings that have been with the Federal Government.

I think that the subsidies are better utilized if you know, if fact, that there is a private lender that is involved in the project, because they have a vested interest in making the project work. You've got somebody else in there. The public sector is not the sole lender in there.

The other thing that you need to balance that as an appropriate subsidy is that which would not necessarily guarantee a return to a developer, because, as Marilyn had said and I think the rest of the panelists will reiterate, that you have to look at a return that is sufficient to all those who are involved on a case by case basis.

From a private lender standpoint, we are going to want to make sure that a developer is invested. I think that's a very important concept for the national policy or Federal programs to keep in mind, where the owner is going to have either some cash in the deal, recourse to the project and other debt, or has deferred fees over a period of time so you do not have the incentive of walking, which sometimes we see when a project goes into trouble.

So, being able to balance an acceptable return with what is an acceptable amount of vesting with the owner, something that is an important concept that the private sector can help the Federal Government to work on.

In closing, I want to also just mention that, as you move forward and you come up with other recommendations or you try and direct Federal policy, what you may want to take into consideration is involving the private sector much more closely. And as the lending industry has gotten smarter in affordable housing, there are different committees and organizations that can be available.

We have a committee through the American Bankers Association that works on community development lending. We also have that as an issue in the Mortgage Bankers Association through our multifamily committee.

And there's also a new organization. That's the National Association of Affordable Housing Lenders. And there are other task forces as well. And I'm sure that there will be many private sector representatives in addition to myself that would be willing and able to help you work on these issues.

Senator **Graham**. Thank you very much.

[The complete prepared statement of Karen Kollias follows:]

TESTIMONY OF KAREN KOLLIAS

VICE PRESIDENT, AMERICAN SECURITY BANK

BEFORE THE

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

HUD/MOD REHABILITATION INVESTIGATION SUBCOMMITTEE

FEBRUARY 27, 1990

Mr. Chairman, Committee members, invited guests and interested participants, I am happy that you asked me to participate in this distinguished panel of development professionals who specialize in low- and moderate-income housing. While the name of your Subcommittee implies a review of previous and current HUD finance products, I will take this opportunity to describe the role of a private lender in structuring the financing of low- and moderate-income housing projects. It is my hope that through my remarks along with the other panelists' testimony, your Committee will be able to piece together what does work with the financial structuring of these projects, what has not worked in the past, and what are the policy implications you need to pull together for any pending legislative initiatives.

Role of Private Lenders

The role of private lenders has become increasingly more important over the past several years while the role of the public sector, the Federal government in particular, has decreased. One problem that these roles have created is the appearance, especially on the part of community organizations and units of government, that private lenders can actually fill the role of the public sector. While this should not be the case, it puts a responsibility on the private lenders to define what our role is, and this definition can assist in developing public policy around the role of government as lender or investor for low- and moderate-income housing projects. I see private lenders as having two basic roles: one being the primary financial investor in a given project, and the other being a proactive member of a project's development team. This latter role is not a traditional function for a private lender, but it is a critical role for both private and public lenders to ensure successful low- and moderate-income housing projects.

- Private Lender as Financial Investor:

  A private lender will have to take into consideration several underwriting criteria including the project's collateral and cash flow. A project's loan amount will be dependent upon how much income is available for debt service coverage. For every dollar of debt, a lender will look for $1.10 to $1.20 as coverage. Financing low- and moderate-income housing projects becomes complicated when the rental income is restricted due to the income of the tenants. The difference between how much a lender may commit to for a project and the total development costs is the gap. This gap traditionally is funded with a combination of subordinate public financing, owner's equity, and/or credit enhancement. Private lenders will be more or less creative or aggressive about their affordable housing investments given their capacity and commitment to such a product.

Another underwriting consideration for private lenders is the loan-to-value ratio requirements. By regulation, lenders are restricted to lend no more that 80% of loan-to-value, and it may be less given other risk considerations. Since income of the project is one of the factors determining value, the value of low- and moderate-income projects will be limited. The two underwriting guidelines tend to limit the amount of private funds available to such a project, but the typical development costs, particularly when construction is involved, are not proportionately decreased. This is the difference that makes up the financing gap which should be a primary focus for public policy attempting to stimulate financing for affordable housing.

Because the private financial institutions have unlimited capacity to structure traditional investments in these projects, public policy should be developed to promote specific examples of public-private partnerships, where the private lenders take the financial lead, and that the limited amount of public funds should be used to leverage and credit enhance private funds to what ever extent possible. This statement does not offset the need for a national housing policy and a sufficient budget to implement the policy. Public policy needs to embrace the importance of flexibility of public resources and their application to local projects since so many affordable housing projects are unique. This is often hard to structure since the policy, and related budgets, come from a national perspective. Priorities should be placed on projects where:

- public funds are highly leveraged; there is additional owner's equity in the project (enough to keep the owner "vested");
- when the specific location of a project is in an area where there is substantial attention and opportunity for

redevelopment; and

- the project ensures "permanency" of affordable rental units for low-income families.

In order to best direct a national policy which embraces local initiatives, attention should be paid to the number of ways in which public/private partnerships should be defined. A consortium of representatives of public and private sector representatives can be assembled to draft partnership examples and/or guidelines.

A specific issue of concern to the Committee is how one balances "risk" and "return" for projects. There is a legitimate concern among public and elected officials that there be an "appropriate" amount of subsidy, as required, for projects. The best way to ensure, from the public sector's standpoint, that there is a balance between risk and return, is to have a private lender involved. A private lender will be knowledgeable about what is an acceptable rate of return for a developer given project risk while making sure that the developer is also vested in the project. This will usually happen in the acquisition and construction stage when the developer is personally guaranteeing the private debt and usually has cash equity and deferred developer's fees in the project. A private lender will underwrite the developer along with the project to make sure that there is an acceptable balance between how much of and when a return can be expected as compared to the developer's initial investment. A private lender will typically not allow a developer to not be initially vested and then receive a return since this provides an incentive for the developer to walk from a project. This is what I assume the public sector also wants to avoid. Therefore, the pubic policy and related programs need to line up subsidies, be they rental or project subsidies, with the private sector underwriting so that these public resources are truly "filling the gap" and not used as "incentives to walk".

- Private Lender as Development Team Player:

  Private lenders are now learning to become more proactive in their investments for affordable housing projects. These roles should be encouraged and incorporated, to the extent possible, in public policies. The proactive roles include:

  - To concentrate financing through multiple investments within designated communities in need of revitalization to ensure a significant and positive impact;
  - To embrace a locally-based housing policy where financial resources are connected to certain locations

and product types. Examples include facilitating the "preservation" of rental projects in communities where gentrification is happening while promoting affordable ownership opportunities in areas where there are dense rental projects;

- To encourage relationships with developers, be they non-profit or for-profit, that have as their "niche" low- and moderate-income housing development. This is a highly specialized industry so both lenders and developers need to be in these projects for the long-term; and
- To scrutinize each project with a neighborhood strategy which would require the lenders to fully understand and accept what other developments are happening in the communities, approving involved property management companies and knowing who are the other "serious" players in the communities.

As private lenders attempt to get more involved in affordable housing projects, they will inevitably end up either working closely with or communicating with local government representatives.

Summary Recommendations

This Committee has attempted to take on a difficult topic and it should be commended for attempting to honestly assess problems previously applied to public policies and programs while shaping future policy recommendations. In the most general of terms, public dollars will be best protected when used in conjunction with private sources and where there are performance controls administered on a local basis. This means that national public policy and the flow of public funds, should be structured to be responsive to and supportive of locally-initiated funding strategies for low- and moderate-income housing. Public and private sector representatives need to educate each other on how to balance the economic viability of these projects with their community benefits. This is directly linked to the Committee's concern of balancing risk, return and subsidies. Problems experienced by previous public programs can be avoided when there are vested, educated and committed local players in the form of developers and lenders.

To the extent that this Committee, or other national representatives, want to communicate more specifically with representatives from the private lending community. There are committees which exist within the American Bankers Association (ABA), Mortgage Bankers Association (MBA), and newly created organizations like the National Association of Affordable Housing Lenders (NAAHL) and Low and Moderate-Income Housing Finance Task Force. These organizations are working to promote the financing of low - and moderate-income housing as a specialized industry which is what public policy officials need to understand. Therefore, any future national policy and budget initiatives should reflect the specialized nature of this type of product and promote as much private sector participation as possible.

Corporate citizenship can enhance the bottom line and help neighborhoods prosper.

AFFORDABLE HOUSING: Business Opportunities FOR Lenders

Karen Kollias and Joseph Tockarshewsky

Affordable housing has been addressed any number of times in this publication and many others. The topic of affordable rental housing was most recently addressed in the November issue of Mortgage Banking. *At that time, my colleague, Leslie Platt and I conducted a roundtable interview with experts who together represented that the demand for affordable rental housing, while most certainly compelling, would not be addressed by the private sector without some measure of public assistance. Further, that same panel of experts identified a number of issues which would have to be addressed to stimulate any meaningful private sector involvement in the financing and ultimate development of rental housing that would otherwise be considered affordable.*

In this second of a series of articles on this topic, Joe Tockarshewsky and Karen Kollias of American Security Bank of Washington, D.C. tell how that institution, working in concert with the District of Columbia, a local mortgage banking firm and Freddie Mac have together been able to finance, through conventional means, affordable inner-city rental housing. The article is illustrative of how conventional lenders, the secondary market, and local government can function effectively to produce housing for those whose housing alternatives have been severely limited due to federal budget cutbacks, tax reform, high interest rates, and a variety of additional impediments.

What this article suggests is that we have the institutional ability to deliver a product for which there is a demonstrable market demand. Further, it suggests that the private sector can effectively participate in the delivery of affordable rental housing exercising traditional lending, investment considerations. The article addresses head on the unfortunate belief, held by many private sector participants whose expertise and resources are needed, that their involvement in affordable housing will require them to give up something or give something else away. If, ever, we are to arrive at a broad-based acceptance of the private sector's role in the financing and development of affordable housing, we must do a better job at defining and ultimately addressing the fundamental bottomline concerns and motivations of the private sector. Conventional lenders, mortgage bankers, and the secondary market cannot and should not be expected, for whatever purpose, to totally abandon considerations which taken together, have maintained the financial strength and fiscal well being of their institutions' over time. While it is a fact that a number of institutional lenders, life companies, for example, have on their own developed policies and implemented programs which address defined social purposes, and those practices and programs are, I might add, absolutely necessary and, should by all means continue, it should also be realized that such programs and practices are and will likely remain limited in scope and budget. At issue in this month's discussion in Mortgage Banking *is whether traditional lending and investment practices and considerations can be applied to meet similar goals and objectives in the area of affordable rental housing, and at the same time meet the larger institutional goals and objectives of the same institutions. This article demonstrates by example that issues and concerns raised in our November discussion can be addressed and indeed should be pursued more aggressively.*

The Multifamily Housing Committee of the Mortgage Bankers Association of America chaired by Donald L. Tripp has been engaged in an analysis of this subject. The Committee wishes to thank Mr. Tockarshewsky and Ms. Kollias for their interest and support in preparing this article. The Committee hopes that this article will initiate a continuing investigation of the delivery of affordable rental housing by the mortgage lending industry.

John F. Bohm
Director
Income Property

The need for affordable housing continues to grow as the traditional public sources of support diminish. We have seen and used the term "public-private partnership" for several years, but now it is especially critical to define the partners and their roles to provide affordable housing. Lenders (both construction and permanent) have both a responsibility and an opportunity to carve out their role in supporting affordable housing projects. Commercial lenders around the country have been increasing their involvement in such projects over the past several years. Their choice to finance such projects has originated from either: the need for public and community relations; the need to perform under the Community Reinvestment Act (CRA) or, the understanding that financing such projects is good business. Lending to affordable housing being good business is the primary focus of this article which is based on our institution's experience, at American Security Bank in Washington, D.C., as well as through our communications with other commercial lenders throughout the country. This article also defines the roles of the various players in the "partnership approach" to affordable housing including the secondary market and mortgage bankers.

Over the past three years, American Security Bank (ASB) has become the District's largest lender for affordable housing projects with 65 percent of its $200 million portfolio commitments attributed to this product offering more than 5,000 rental units and more than 250 ownership units. This major investment has stemmed from the creation of the Bank's Community Development Group which is a profit center in the real estate division. What was unique, particularly three years ago, was that CEO and chairman Daniel Callahan had the vision to understand that the bank could offer community development lending, like any other bank product, and have it be good business. Basically, the lending group structures and offers financing for projects that are both economically viable and offer significant community benefits. It is not surprising then that most of our loans are to affordable housing, basic commercial/retail projects and community-based facilities. Neighborhoods (mostly in the District) in need of development and/or stabilization are the areas the bank targets for investment. This action is not typical of the bank's standard practice of "spreading the risk around" in each industry, but concentrating in neighborhoods is a requirement for community development lending to be effective. In fact, we say that only the first investment may be considered at (geographic) risk, and that every loan after the first protects the bank's original investment. By concentrating financing in specific communities, we quickly learn about most developments (social, political, physical) in these areas and get involved beyond the traditional investments. The bank essentially becomes a "corporate citizen" which, for us, has proven to be a very necessary role in public-private partnerships.

The underwriting we apply for community development projects is the same as the criteria applied for any other real estate transaction. The only differences are: what criteria are emphasized; how much time is involved in the financial structuring of the projects, and understanding all the various sources of finances that can be combined with bank debt to make community development projects work. Because there are so many moving parts, the transaction is dynamic until the closing at which time a balance is achieved. Patience is a necessary attribute of a development lender.

Project-based underwriting emphasized

Of the basic four C's in underwriting (credit, character, cash flow and collateral), the two factors relating specifically to a project cash flow and collateral are the ones that are stressed for community developments projects. This is not to say that the project sponsorship is overlooked, but it does mean that a broader base of developer/owners are often involved in such projects including non-profit organizations and small "entrepreneurial-type" developers. This diversity of sponsorship, we have seen, does include large developers who see the same opportunities as the bank in undertaking specific housing and/or commercial projects in urban communities. In underwriting the specific project, we apply assumptions that a permanent lender would look at particularly with respect to interest rate, amortization, loan-to-value and debt service coverage ratios. With some housing projects where additional (subordinate) sources are involved, we see loan-to-value ratios which are less than 80 percent. Projects' cash flow, when stabilized, will usually achieve 1.15 coverage that is the desired coverage for most permanent lenders. The bank will provide loans that allow acquisition, construction/rehabilitation and lease-up/stabilization for housing projects which often means terms of up to three to five years. While this is also not typical of standard bank policies, we thought it was necessary to enable projects to show adequate operating history for permanent lenders. A majority of the housing projects we finance are either unoccupied or partially occupied so there is little likelihood that a permanent mortgage will be committed at the same time we commit our acquisition/construction loan.

Most community development projects, and affordable housing in particular, are very complicated.

Most community development projects, and affordable housing in particular, are very complicated. This is due to a number of reasons which include: pinning down an adequate scope of work for construction; tackling issues like rent control and/or "tenant-in-place" rehab; understanding the financial requirements for both the development and operation of the project; indentifying and plugging any financial gaps; coordinating multiple sources of finance; finding comps for appraisals; reviewing and approving management plans and actually handholding some projects and/or their sponsors. Because lenders usually do not get "heavily involved" in the pre-development of projects, anyone considering financing such projects needs to know that the process is very time-consuming. Being a real estate specialist helps a lot and having good development team players on behalf of the bank (i.e., appraisers, attorneys and inspectors) is a requirement. Management capabilities is a key skill for the developer. A daily involvement with the tenants and the community is a must for the success of the project in the early stages of construction and rent-up. As well as, after completion when there is the need to prevent the new units from reverting back to its former state.

There are several other sources of finance available for affordable housing. Lenders need to know what are the various sources that can be combined with their loans for such projects. Given the nature of affordable housing, most projects' restricted income will not be adequate to repay debt service, so there are often financial gaps. These gaps usually are filled with equity, but the traditional sources of equity (i.e., through the use of investors as limited partners) have been reduced particularly with the changes in the tax laws. We have, therefore, become comfortable with what we term "synthetic equity" which includes subordinated debt from public sources. With many projects, we work closely with the District government (or federal depending on the nature of the public programs) and we have learned about all the public sources, their requirements and how they work. If the sponsorship is a non-profit organization, the project may also have other resources available to it beyond government funds. A good example is the Local Initiatives Support Corporation (LISC) which provides equity investments into projects that are sponsored by non-profits. There are local LISC organizations in most urban areas. Getting comfortable with the various sources of "synthetic equity" also means we often approve subordinate deeds of trust. In some instances where projects are developed on previously publicly-owned land (or when specific federal funds are used), we may have recorded covenants which are superior to our deed of trust. Other lenders will have to get comfortable with and knowledgeable about these other sources of finance if they want to take on affordable housing. This is especially important for permanent lenders to understand because many are not used to (or do not allow) other sources of finance in their projects even if they are subordinate to the lenders' mortgage.

The more financing of affordable housing projects we do at the bank, the more we learn about the changing housing needs and their financial requirements. This has enabled us to develop loan products which support limited equity coops, transitional housing projects and infill projects sponsored by non-profit organizations. We have recently agreed to provide a direct equity funding for a large rental project and we are in the process of creating a bank-owned Community Development Corporation (CDC) to offer equity financing to low-income permanent rental and transitional housing projects.

Although it seems as if every project we finance seems different, there are some that seem fairly representative of what lenders, both construction and permanent, can expect when taking on affordable housing projects. The following are such examples:

- Hartford Street: We provided a $1 million loan to two individuals who formed their own development company. The loan enabled them to purchase 36 vacant units in three low-rise apartment buildings in a neighborhood that had a high percentage of abandoned buildings. There were no other sources of finance besides the developers' equity and the bank loan, but there were rental subsidies for the low-income tenants who would move in. Because of the demand for rental housing in the District neighborhoods and given the rental subsidies, the project was 100 percent occupied upon the completion of rehab. We introduced the developers to a mortgage banker who began working on permanent loan commitment. An initial concern that the mortgage banker raised with respect to the secondary market was the amount of abandonment around the project site. We prepared a summary of all the bank's commitments that we issued for that immediate neighborhood and when construction would begin and end for each project. This gave the mortgage banker the information he needed to get the permanent lender comfortable with the project in the context of the neighborhood. He also made the case that the fast lease-up and the guaranteed income (in the form of rent subsidies) should offset the fact that there was not a significant period of stabilization. Freddie Mac bought the loan from the mortgage banker. ASB originally had committed to provide a "mini perm" after construction because we were creating the market in the neighborhood so we were not sure whether or not there would be any interest in the project from a permanent lender for several more years. With the Freddie Mac commitment, we never had to fund the "mini perm."
- Gainesville Street: Immediately behind Hartford Street, a non-profit organization purchased three identical buildings containing 36 vacant units. The bank provided a construction loan of just under $1 million. One of the buildings was sold to the non-profit from the city. In addition, the project required gap financing which came out of two different public sources. Given these sources and the disposition of one of the buildings from the city, there were three subordinate deeds of trust behind the bank. There was also a covenant recorded that required the owner to keep the project available to low-income families. We asked our mortgage banker to look at the project during construction to determine early on how a permanent lender would react to this project given its restrictions. Involving the mortgage banker early on was helpful because he was able to explain to the permanent lenders how the project was structured and why. At this time, construction is nearly complete and one of the buildings is already leased. We expect to be taken out by

The lenders in any partnership need to include mortgage bankers, the secondary market and life insurance companies.

either Fannie Mae or Freddie Mac in 1989.

In both of these examples and with other projects where we have already been taken out with permanent loans, the mortgage bankers have played a critical role as "advocates" for these projects. Now, as a matter of course, we involve mortgage bankers in the projects early on so we are aware of concerns that may be raised by permanent lenders with different types of projects. Active involvement of mortgage bankers also helps expose the permanent lenders (Fannie Mae, Freddie Mac, FHA insured programs, or life insurance companies) more directly to these projects.

Who are the public and private partners

When people use the term "public-private partnership" most assume the partnership implies banks and local government. However, in the case of affordable housing, there are many partners especially on the private side and each play a very important role in the partnership. The lenders in any partnership need to include mortgage bankers, the secondary market and life insurance companies. If the secondary market were more involved in financing affordable housing projects, it would help increase the activity of construction lenders. Banks generally still perceive that there is not an active secondary market for these projects, so this either prohibits or limits the banks' involvement in affordable housing. Most banks are either not willing or unable to hold many projects in their portfolio which is the only alternative to selling the loans to the secondary market.

In addition to the variety of lenders, developers are also a part of the "private" side of the partnership. Developing and managing affordable housing projects requires tremendous capacity, so it is in the lenders' interest to work as closely as possible with a diversity of developers. Lenders should become comfortable with the diversity of developers who are the ones taking the risk with such projects including the smaller, entrepreneurial developers as well as non-profit organizations. Lenders should also be aware of the other sources of equity which are not from the government. These sources may include LISC (or other sources uniquely available to non-profits) and other third party equity investors. Some investors, including corporations, have taken equity positions in low-income housing projects through the purchase of low-income housing tax credits. Fannie Mae is a good example of a corporation that has provided equity in projects around the country using the tax credits.

Our experience at ASB has shown that financing affordable housing projects is good business. Our lending group's return on assets is consistent with most real estate lending groups. Many lenders are hesitant to get involved in financing such projects because they perceive that they would either have to provide concessionary rate financing or that the projects are not really economically viable. Neither of these perceptions is true and we are trying to get "our word out" through organizations like the American Bankers Association (ABA) and the Mortgage Bankers Association (MBA). A lot of work remains to be done to encourage mortgage bankers and permanent lenders to get involved in affordable housing as a "traditional" loan product. Right now, for example, when life companies provide permanent mortgages on such projects, it is usually through their social investment programs which have limited available funds. Mortgage bankers, for the most part, do not actively seek out these types of projects because they do not see affordable housing as a "market niche" opportunity. We, at the bank, have been fortunate to find aggressive and committed mortgage bankers who understand affordable housing projects the same way we do.

We involve mortgage bankers in the projects early on so we are aware of concerns that may be raised by permanent lenders with different types of projects.

There are some actions that mortgage bankers can take to get more involved in affordable housing. These include:

- Getting to know what interest there might be with their correspondent life companies in financing these projects;
- Getting to know what Fannie Mae and Freddie Mac are doing to be more responsive to affordable housing;
- Finding out what the local commercial lenders might be doing in affordable housing and how they are underwriting such projects;
- Talking to some developer/customers that are active in multifamily housing to gage their interest and/or involvement in affordable housing;
- Learning about the various public finance programs that are often used for such projects, and
- Getting familiar with the various communities where the housing needs are the greatest which, in turn, means where there is project opportunity.

Finally, mortgage bankers can stay in touch with what is happening nationally to promote affordable housing because there are a few organizations with this purpose. The MBA has a committee on affordable housing and the ABA has a subcommittee on community development lending. A National Association of Low-Income Housing Lenders has recently been formed and the life insurance companies have a Center for Corporate Public Involvement that coordinates the various social investment funds. Fannie Mae has an entire division for low- and moderate-income housing initiatives.

We hope to see more involvement during the next several years of mortgage bankers and permanent lenders in affordable housing. Not only because it is good business, but we all have a shared responsibility to be a part of the public-private partnerships that are necessary to meet the increasing housing needs of low- and moderate-income families. **MB**

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ABA BANK COMPLIANCE
JULY/SUMMER 1989

In addition to attracting new businesses and jobs to Roxbury, the Parcel to Parcel Linkage Program will also provide funding for the development of affordable housing, child care facilities, and job training programs. By investing a modest amount of capital, but a great deal of time and political influence to this project, Boston Bank of Commerce has been able to create opportunity where, before, there was none evident. We helped to bring together the resources of our community in a common project that enabled us to achieve considerable leverage.

Conclusion

Our involvement with the Parcel to Parcel Linkage Program is very unique, and most banks across the country may not be able to engage in community reinvestment projects of this magnitude. However, it is incumbent upon all banks, regardless of their size, to engage in reinvestment on a variety of levels. By involving senior management in community organizations, permitting the loan of bank facilities and resources as in-kind services for non-profit or community-based groups, and engaging in fair mortgage and small business lending activities, banks can become active partners in the communities they serve.

It may appear that our level of community involvement and reinvestment is easier to achieve because we are a small bank or because of our minority ownership. However, the same type of commitment can and should be incorporated into any bank's business objectives and carried out through neighborhood and regional activities.

It is to the advantage of all members of a neighborhood to promote an improved quality of life. The local bank should be a part of the process of empowering the community if it wishes to remain in that community.

If our industry adopts this posture we will not recoil at community reinvestment. We will instead help to define effective community investments. In doing so, we will build stronger banks and a stronger nation.

American Security Bank: A Proactive Community Lender

by Karen Kollias with Jeannine S. Jacokes

***Karen Kollias** is Vice President and Head of the Community Development Group, American Security Bank, Washington, D.C. Her background includes service as a neighborhood development specialist with the Department of Housing and Urban Development (HUD) and a project director for the National Center for Urban Ethnic Affairs.*

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For those banks that have not seriously thought through a community lending initiative, two recent actions should certainly grab their attention. The first action was the Federal Reserve Board's denial issued to a large midwestern bank on its request to acquire another institution. The grounds for denial included the bank's lack of CRA lending activity. The second action was the publication of the federal agencies' new Community Reinvestment Act Policy Statement. This statement describes the requirements of "expanded" CRA statements, which now must include a description of the bank's overall CRA policy and a summary of how the policy was developed.

Simply put, both actions send a clear message to banks that, on the regulatory level, more importance is being placed on CRA-related activities. It is also apparent that the federal government expects banks to be more proactive in their community investment activities. It is no longer acceptable for banks to react to project-specific community pressure. Today, bankers are presented with a new challenge: to become proactive community development players. The purpose of this article is to demonstrate why it is good business for banks to initiate community development activities. One example of a successful proactive lender is the Community Development Group of American Security Bank (ASB), N.A.

Corporate Vision

In March 1986, American Security Bank created the Community Development Group, a lending group in its Real Estate Division. A combination of the following factors helped contribute to the creation of this group:

- ▶ The Chief Executive Officer and Chairman of the Board is a Washingtonian and has a strong personal belief in and commitment to the District of Columbia and its communities.
- ▶ ASB has participated in community development projects in the past, but it had not widely publicized this type of involvement.
- ▶ ASB brought in a new Executive Vice President in charge of the Real Estate Division, the largest division in the lending bank, who had extensive experience in real estate lending and deal structuring and was an active deal maker—a vital factor for community development investments.
- ▶ ASB wanted to show that locally based lending institutions were capable of addressing community development financing needs without having to bring in outside national money center banks to "get the job done."

With this background, the Community Development Group was established. The group's objective was to provide loans to District neighborhood projects that were both economically viable and beneficial to the community. Because the lending group was a proactive creation and not started in reaction to a CRA challenge, it was treated as a profit center in the bank. No maximum or minimum dollar amount guidelines were set for the group. Thus, it was up to the staff to determine how and where the group would target its efforts, as well as what loan products would be offered. This latitude provided an attractive opportunity for the bank to be an active community development player. Since its inception, the group has originated over $200 million in community development commitments within District of Columbia neighborhoods, and it has grown from a staff of one to a staff of nine. ASB has become a strong promoter of community development as a specialized loan product for banks.

Setting Goals and Developing a Strategy

This brief summary of how ASB's Community Development Group operates may serve as a guideline for other banks seeking to get involved with community development.

The bank had a vision of what it wanted to accomplish as a community development lender. With that vision in mind, it created a policy to direct the lending group. The policy reflects the notion of the bank as a corporate citizen to the extent that it concentrates its resources in specific neighborhoods, understands the market conditions and investment requirements of the neighborhoods, and participates in the social, economic, and political activities that are important to developing neighborhoods.

The bank identified neighborhoods to target for investment by using several criteria. These included the staff's experience and knowledge of market conditions and comparables, the need for reinvestment, the availability of a project to develop or redevelop, the staff's ability to concentrate enough resources to turn the neighborhood around, and the ability to attract a variety of developers to work in the neighborhood. In many cases, the neighborhoods identified by the bank were also targeted by the city, meaning that there also would be access to public finance sources for development projects. In addition, supportive nonprofit and community-based groups were active in the identified neighborhoods.

In selecting the types of projects to which it would lend, the bank focused on the needs of communities undergoing revitalization. Therefore, the current portfolio consists of the following types of projects: low- and moderate-income rental housing, homeownership and cooperative conversion projects, commercial/retail projects, and community-based facilities (e.g., church construction/permanent loans).

The bank determined what finance products were necessary to accomplish community development projects. As a result, the Community Development Group is able to provide in one place all the products found in other parts of the Real Estate Division. These include land and pre-development loans, revolving lines of credit, acquisition and construction financing, mini-permanent loans, and in some unique cases, permanent loans.

As a proactive lender, the bank developed products for specific purposes, as illustrated by the following examples:

▶ *Church loans.* The bank acknowledged that church membership in the District continued to grow, and in many communities, churches are offering an array of neighborhood services. Churches came to the bank with requests to finance the construction of larger places to worship or the development of mixed-use facilities where they could operate their social service programs. Because churches are seen by the bank as important community development participants, a loan product was developed to finance church construction or church-sponsored, mixed-use facilities. Since there is no organized secondary market for these loans, the bank also commits to permanent mortgages, using a variety of adjustable rate instruments. To provide continuity among the church loans, the Community Development Group assigns one officer to handle these projects as a part of his or her portfolio.

The criteria the bank applies for these loans include: evidence of the church's ability to handle a building fund (for the repayment); review and approval of development team members; type and amount of involvement in the community where the facility is to be located; and use of a qualified real estate consultant if the church does not have its own development capacity.

▶ *Co-op loans.* The bank entered into a memorandum of understanding with the National Cooperative Bank (NCB) to provide "one-stop" financing for tenant-sponsored co-op conversions. This understanding basically eases the process and shortens the time involved for the co-ops to secure financing, which had in the past been pieced together. Together, the bank and NCB came up with mutually acceptable requirements and prepared application forms. Both institutions underwrite in concert so that the co-op gets both commitments at the same time. ASB's acquisition and construction commitment is conditioned on the receipt of NCB's commitment letter. Closing on NCB's commitment occurs when construction is completed and the required percentage of co-op sales has occurred.

ASB monitors these activities during the construction phase. One officer from each bank is assigned to handle the loan requests and develop a good working relationship with the nonprofit organizations and private consultants who represent the tenant groups. The groups have appreciated this joint effort because it allows them to line up all the financing at one time and to deal with the same people for each project.

▶ *Mini-permanent for rental housing.* When ASB began aggressively lending for multi-family housing projects, a majority of the inventory consisted of abandoned or partially occupied buildings with no significant, if any, operating history. The bank could not expect to find a deal with a permanent lender already committed. So, unsure of the secondary market's appetite for "gut rehab" of medium-sized buildings for low-income tenants, the bank routinely has offered a mini-permanent loan of 3 to 5 years, (fixed or floating) after the project was renovated and occupied. It was assumed that the bank would hold the loan until it was seasoned enough to establish a permanent mortgage. In this way, while the bank responded to the perceived need for longer-term financing, it also actively pursued existing secondary markets. The bank has discovered that the secondary markets respond to many projects once they are leased, thus enabling the bank to shorten the terms of its mortgages.

CRA SUCCESS STORIES

As a proactive lender, ASB is committed to developing new financing techniques that make community development initiatives work. Currently, the bank is creating a bank-owned Community Development Corporation (CDC). To be operational by the fall of 1989, the CDC will be able to make equity investments in projects that create permanent low-income rental housing or nonprofit, sponsored, transitional housing.

Another example of the bank's commitment to the development of financing mechanisms that work occurred when nonprofit co-op sponsors told NCB and ASB that longer-term, nonadjustable interest rate, blanket mortgages are required for limited equity co-ops. A minimum 10-year term was recommended by the nonprofit organizations, which identified specific projects that needed a 10-year fixed rate mortgage. To address this problem, the two institutions pulled most of the District's local commercial banks together to discuss the creation of a loan pool offering longer-term financing for qualified projects. Based on preliminary discussions, it appears likely that a loan pool will be created in 1989.

Developing Partnerships

In addition to the operating procedures already described, other factors have contributed to the success of the ASB Community Development Group. These factors include the group's definition of and commitment to public-private partnerships and the makeup of the staff and its technical expertise.

▶ *The borrowers.* The Community Development Group has been fortunate to attract and maintain a diverse base of borrowers, ranging from large developers to small, entrepreneurial developers and nonprofit organizations. The diversity of developers reflects the variety of community development projects needed in the city's neighborhoods. The bank invests much of its time and energy into institutionalizing relationships with borrowers. This is critical because the deals are labor-intensive and it helps not to have to learn about a new borrower with each project.

The bank has learned to respect the technical capacity of certain nonprofit groups and to appreciate that, but for the efforts of these nonprofit groups, certain projects would not get done. Specifically, nonprofit groups have access to alternative sources of finance (equity) that for-profit developers may not be able to obtain. Also, because they are not driven by traditional profit motives, nonprofit groups are often able to make marginal deals work economically.

▶ *Staff and technical support.* The bank learned early that the capacity of its Community Development Group staff is critical to the success of its projects. Just like the underlying proactive philosophy of the group, each staff person needs to understand the development process and the bank's role in that process, be a real estate specialist with expertise in renovation, and have an understanding of how neighborhood conditions can affect specific projects. The bank recognized that the staff must be community development advocates. Working on these projects is extremely labor-intensive, so the staff must be *committed.* Finally, it is essential that a reliable team of support technicians be identified, including appraisers, inspectors, and attorneys.

Community Development Is Good Business

ASB has discovered that financing community development is good business and can be profitable. For example, the bank has an annual goal of 1 percent return on assets (ROA). The Community Development Group's ROA is slightly above 1.6 percent, which is more consistent with returns from other real estate groups. With proper underwriting and administration, community development loans do not appear to present any additional portfolio risks. Out of 160 loans originated, only one has defaulted and has been foreclosed. The remaining 159 loans are performing with no past-due problems.

Contrary to the belief of many lenders, underwriting criteria do not have to be drastically altered to accommodate community development projects. Of the basic four C's in underwriting (cash flow, collateral, credit history, and character), ASB has learned that an emphasis on the project-based criteria of cash flow and collateral is necessary. This is not inconsistent with the fact that a loan is based on the value of the underlying real estate.

The other issues the bank has addressed pertaining to underwriting include: treating subordinate sources of finance as synthetic equity; calculating debt service coverage ratios only for the bank's debt; and accepting other sources like reserves, guarantees, or letters of credit if cash flow is light, particularly in the project's first years of operation.

Application to Other Banks

Through informal networking, community development lenders have been able to share their experiences and lessons learned. There is an acknowledgment that this networking should become more formalized and reach out to banks that are currently not active in community development. To assist in this networking, two national activities are worth watching. One is the formation of the National Association of Lenders for Low and Moderate Income Housing, which was created by several active banks in California and is spearheaded by Wells Fargo. The other national activity is the recent creation of the ABA Subcommittee on Community Development Lending. The objective of this subcommittee is to promote community development lending as an industry product.

Besides these industry-initiated efforts to get banks involved, the regulatory agencies will continue to promote community development initiatives and assist banks in establishing partnerships and programs.

The Challenge

Community lending can open new possibilities to banks that have not yet accepted the challenge of becoming proactive community development players. Banks should take the initiative and define what they want to do with respect to community development and not be prompted into action because of a negative CRA exam or challenge. By initiating their own community activities, banks can build on their existing strengths, matching the banks' abilities with the community's credit needs. Being proactive, rather than reactive, will also allow banks to develop and test new loan products.

It is hoped that, with the encouragement and direction of the regulatory agencies, the support of national networks, and the many positive initiatives of lenders like ASB, banks will refocus their perceptions of community development lending. As the ASB experience demonstrates, proactive community lending is not only good for the community, but it is good for business.

Washington Development Corporation: A State-Wide Effort of the Washington Bankers Association

by Cliff E. Cook and Keith S. Hopper

Cliff E. Cook is Vice President and Compliance Officer of the Puget Sound Bank in Tacoma, Washington. In this capacity, he oversees compliance for the Puget Sound Bancorp. Among many other professional activities, Mr. Cook serves as a member of the ABA's Compliance Executive Committee and was recently appointed to the Federal Reserve Board's Consumer Advisory Council.

Keith S. Hopper is Staff Counsel and Director of Governmental Affairs at the Washington Bankers Association, Seattle, Washington.

As in many areas of the country, Washington State has been experiencing a merger and acquisition environment, as well as a reawakening of community activism. As a result, community leaders have seized on CRA as a regulatory litmus test, and bankers have quickly come to appreciate the cost and delay that can result from a CRA protest. Additionally, regulators have conducted extensive hearings and given new weight to an applicant bank's record of meeting community needs.

Although banks in Washington State were, by and large, doing a good job in their CRA efforts, it became clear to the Compliance Committee of the Washington Bankers Association (WBA) that a more concerted effort was called for. As a result, in 1987 WBA formed a task force to address CRA compliance issues. The task force considered new and creative ways to enhance the CRA performance of banks and to increase the effectiveness of these programs.

The task force was comprised of compliance and lending personnel from both commercial banks and thrift institutions. In recognition of the importance of its objectives, the task force received pro bono services from the Seattle law firm of Davis, Wright & Jones and the accounting firm of Ernst & Whinney.

In the wake of this renewed emphasis on CRA compliance by Congress, federal regulators, and community groups, the task force wanted to accomplish three goals:

▶ provide WBA members with guidance on how to satisfy both the regulators and community groups concerning community reinvestment;

▶ provide a source of funds for small and minority businesses, affordable housing, and other community revitalization and development projects; and

▶ help fend off remedial CRA legislation in Congress through strong industry initiatives.

Recommendations

To meet its three goals, the task force recommended that the WBA help educate its members on how to comply with both the letter and the spirit of the CRA. This would be a continuing effort accomplished through WBA-sponsored compliance seminars and bulletins.

Although the task force was concerned about the increasing CRA compliance problem, it was soon evident that the lack of affordable low- and moderate-income housing programs and the scarcity of government funding programs for other community development projects were also common concerns among the members. Therefore, the task force also recommended that the WBA support the formation of a state-wide, multi-financial institution, community development corporation (CDC). The purpose of such a CDC would be to provide funding assistance for a diversified number of projects targeted in low- and moderate-income communities throughout Washington State. The CDC would be open to investment by all Washington commercial banks and thrift institutions.

The task force did not initially consider creating a CDC. Early discussions focused on how the trade association could help its members meet CRA requirements. Originally the plan was to match an inventory of existing bank and government programs throughout the state together with a listing of community needs. Although the task force believed this information would be useful, it concluded that a larger role was appropriate.

Not a "Big Bank" Only Issue

Historically, small institutions have not been subject to the same standard in CRA examinations as their larger competitors. For many community banks, CRA compliance amounted to a statement filed away like other "important" documents, only to be retrieved annually for a "blessing" by the board of directors. While most of these banks have been active in the economic development of their respective markets and sensitive to community needs, it is now clear that regulators require a much more formal documentation by all banks of their CRA actions and participation in community reinvestment programs.

For community banks, participating in this type of industry approach to CRA would enable them to work with professionals experienced in dealing with sometimes difficult and marginal credits, as well as allow them to be viewed as leaders in development projects in their respective communities. Additionally, the CDC would provide a source of information on the latest government guarantee programs and other public/private funding programs available to assist banks in their community development lending.

Not a "Give-Away" Program

Once fully funded and operating, the Washington Development Corporation (WDC) will be an independent, for-profit corporation organized to address long-term community development problems. The WDC is not meant to be a give-away program; it will be a viable corporation operating under—

Senator **Graham**. Mr. Baskin.

STATEMENT OF SHELDON BASKIN, ATTORNEY, CHICAGO, IL

Mr. **Baskin**. My name is Sheldon Baskin. I'm a low-income housing developer from Chicago. Marilyn told me I only have 5 minutes for a statement, so what I want to do is summarize a memo which I've submitted to the committee.

First, I think low income housing tax credits should be refundable. That would eliminate the syndication process and I can go ahead and discuss that at much greater length later.

Second, I question the concept of subsidizing housing through the Tax Code. I know that it's been easier politically than direct subsidize. I've been a beneficiary of that approach, and I do support the tax credit program because it's the only program we have.

But, I think, in a more perfect world a direct subsidy is more efficient and a better way of subsidizing housing.

In terms of how much subsidy is necessary and what's the appropriate profit, the Government's job is to balance the possibility of windfall, which is a waste of Government money, against the possibility of not giving developers enough incentive and, therefore, not having the private sector participate and not achieve the social purposes of the programs.

I think there's a tendency to move toward nonprofits in the low-income housing development business, and I think that nonprofits play a very important role. But, if we're really going to deal with the problem in the dimension that we have it, we will need the for profit sector.

Even the nonprofits need to recoup their overhead and make a profit in order to stay in business because their sources of funding are declining.

On the other hand, I think the Government has to be careful not to be so concerned that some developer may make a windfall, that a lot of poor people don't get housed. And that's, in my view, what happened to HUD last December when they let a lot of funding die because they were afraid that perhaps this committee would criticize them if they approved a project which had somehow too much profit in it.

In fact, not only is the overall funding of subsidized housing going down, but the development community doesn't see the profit potential as being sufficient, which is evidenced by the fact that most low-income housing developers are no longer in the business. The people who built the 236 projects, the section 8 projects, are not doing low-income housing development any more. And no one is taking their place; there has been some increase in the nonprofit sector, but not in the for profit sector.

In my memo I discuss some of the alternatives that real estate developers have because that's relevant to what kind of incentives you have to offer to bring them back into low-income housing.

Furthermore, firms like ours have to compete for talent with the private sector, with conventional real estate developers, also investment bankers, law firms, accounting firms. We have to be able to make enough money to hire competent people; this is a very, very complicated business, as I think you can begin to understand from Mr. Baron's presentation.

In my memo, I then go into what does the developer put into the project that he ought to get compensated for, which includes his overhead, capital, payment for land and architects, and so forth. Also, guarantees, some of which go on for many years.

A developer also works on a lot of projects that never get built or don't make money; You have to make up for those with the ones that do.

I have a description in the memo of a project that we did. A gentleman asked this morning whether Mr. Baron's project was typical and he said something like 37 out of his 40 were pretty much like that. The one I've described in the memo is only 30 units but, if anything, it had more subsidy sources and more players involved than the Brewery. It was similarly very complicated. That's what we've come to today even to do small low-income projects.

I talk about the sources of profits for real estate development. Traditionally, you could earn developer's fees, leasing fees, management fees and the value of the equity, which includes cash flow, tax benefits and residual values.

To summarize, in low-income housing, especially with the tax credit as it was passed for 1990, all of those sources are very limited, if not eliminated entirely, for low-income housing.

That has to be taken into account when setting a limit on developers' fees. These other sources are not available.

I have some suggestions in the memo to begin to get at some kind of formula for what a developer's fee ought to be, although I think that's really impossible to say.

In the free market, it's determined by the market; that may not be possible to do with these programs, because you have to decide how much subsidy to give.

But I think it's an extremely difficult thing, especially because you're limiting the profit on the upside, but you don't really limit the developer's downside; the cost overruns and so forth are still the developer's responsibility. It's not like a public utility, where the government gives them a monopoly.

The last point on what the Federal Government's role has to be. The Federal Government basically has the taxing power. If we're going to deal with the housing problem, the Federal Government has to come up with the money.

I would like to see that money administered by HUD. I don't necessarily disagree with the community development block grant concept, but even in that, HUD has a big role. And the big problem today is that HUD is incapable of administering anything.

I discuss briefly in my memo some of what I think is wrong and what I think has to be done for HUD to get back to what it was some years ago as a really viable agency with a mission.

Thank you.

[The complete prepared statement of Sheldon L. Baskin follows:]

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MEMORANDUM

To: United States Senate HUD/Mod Rehabilitation Investigation Subcommittee of the Committee on Banking, Housing and Urban Affairs

From: Sheldon L. Baskin

Date: February 27, 1990

Re: February 27, 1990 Hearing: Anatomy of a Deal

The subject of subsidies for low and moderate income rental housing has to start with a discussion of the low income housing tax credit. As a developer of low income housing, I obviously support the credit. But it does remind me that somebody famous once said that democracy is the worst system of government except for all of the other ones that have been tried. The low income housing tax credit is a little like that. It is the worst method for subsidizing housing except for any other program that we are likely to get from this Administration.

The program could use some additional tinkering, but if it is to remain on the books as a tolerable program, it must be revised in one major, but relatively simple, way: the credit must be "refundable."

The low income housing tax credit as it now stands is a very inefficient use of federal tax dollars:

a. Investors pay 50¢ to 70¢ for each tax credit dollar they receive -- and that assumes they are paying nothing for tax losses, cash flow or the residual value of the real estate they invest in. In other words, they are really paying less than that -- in some cases much less -- for the tax credits.

b. Until 1990, the credit could not be used by the high income investors who previously supplied most of the equity for low income housing. Now it can be used by any investor, but only in relatively small amounts by any one individual investor. The result is that most low income housing tax credits were sold, and will probably continue to be sold, to small investors through publicly syndicated funds. These funds require the use of a large network of brokers, who have to get their 8% off the top -- in fact, it's not much compensation for selling a very complicated $5,000 or $10,000 investment. But the securities liability laws being what they are, the brokerage firm has to show the deal to its lawyers, and the lawyers will require the firm to do its due diligence -- appraisals, feasibility studies, and have their own accountants run projections and do a tax analysis in addition to the ones done by the syndicator and/or developer. The syndicator has to pay its lawyers, financial analysts and marketing people and make a profit. Furthermore, the profit has to cover deals the syndicator bids on and negotiates on but which are never consummated. The net result is that only about 73¢ out of every $1.00 paid by the investor ever gets to the developer -- which is, after all, who you are trying to incentivize to get the housing built.

The only exception to this process is the large corporation, such as the public utility which invests for the public relations benefit, or the bank which invests to get Community Reinvestment Act credits; however, to the extent that these investors may pay more for the credits, one can assume that they would be investing that increment in community economic or housing development anyway.

So we now have a system where for every dollar the Federal government gives away for low income housing, the creator of the housing gets only somewhere between 35¢ and 50¢. It's not quite that bad because this analysis does not take into account the discounted present value of the credits or of the payments to the developer, but it is still a very inefficient system from the government's point of view.

The solution is to make the tax credit refundable, thereby eliminating the necessity for syndication. This is not a radical concept. For example, the 1986 Tax Reform Act created refundable tax credits for the steel industry. The concept is simply that taxpayers (or tax-exempt owners) whose credits exceed their tax liability receive a check from the IRS for the difference. The program would cost the government no more than the existing program.

However, there is no "lobby" for refundable tax credits. Eliminating the need for syndication is unpopular with syndicators, tax lawyers and accountants. For years, politicians have criticized the syndication process as a method of raising money for low income housing. They have blamed syndicators and real estate, legal and accounting professionals as well as investors for their role in the process, a role which was, of course, created by the Congress. Although the criticisms were generally off the mark based on a misunderstanding of how the process works, why not eliminate the need for syndication?

This would not only provide more low income housing "bang" for the tax credit "buck," but it would be a boon to non-profit developers, some of whom find it necessary to joint venture with for-profit developers in order to syndicate their projects. In fact, I myself have been a beneficiary of this process. I have enjoyed the opportunity to work with non-profits, and in some cases it has even been profitable. But it should be unnecessary where the non-profit is capable of developing housing in all respects except that it does not have the necessary credibility in the investment community required for syndication.

There are non-profit syndicators who specialize in packaging syndications for non-profits, but in most cases either the investors knowingly overpay for the Community Reinvestment Act or public relations benefits, or the non-profit receives a significantly discounted price. Incidentally, these non-profit syndicators also have a stake in the system as it is.

There would be some technical and policy issues that would have to be dealt with if the credit were made refundable, but these issues are relatively easily soluble once the basic concept is accepted. I am told that the Congress would never approve a refundable credit because of technical reasons related to Gramm-Rudman and the budget process. But I would prefer not to believe that the same Congress that was apparently outraged by how HUD administered and the private sector participated in housing programs created by the Congress, most of which was apparently quite legal, would itself lack the courage to correct its housing programs because of self-imposed procedural obstacles.

Perhaps a more basic problem with the low income housing tax credit program is that use of the Internal Revenue Code is an inherently inexact method of subsidizing anything. It's too broad brush. It doesn't pinpoint the government assistance to where it is most needed or has most impact. But at least it reduces administration of the program in most cases. Accelerated depreciation for low income housing, for example, didn't really need to be administered by the government except for the usual IRS presence to cut down on cheating.

But the more you try to pinpoint the assistance through the Code, the more administration is required, without ever achieving the full benefits of a directly administered subsidy program. The 1990 version of the low income housing tax credit has now reached the point where there is more administration of the program, at a greater cost to the taxpayer, than if it were a direct subsidy program. In addition to HUD's oversight and participation, more than 50 separate government agencies have to develop sufficient expertise and put in the time and effort required to develop a system for rating projects as to their relative merits for purposes of funding, and then to determine how much tax credit is "needed" by each and every project. In order to determine how much credit is needed, each agency has to decide how much profit a developer should make and how much overhead the developer is entitled to be reimbursed for. And all this with no assurance that the administrative effort will be justified by an extension of the credit program beyond a single (underfunded) year.

I would suggest that trying to implement such a program through the Federal income tax code just doesn't make any sense. The program ought to be administered through HUD. For example, where HUD insured mortgages are involved, a developer profit could be built into the mortgage and funded by the mortgage. Again, there are certainly problems that would have to be dealt with to implement such a program, but the end result, although not perfect, would be better than the present system. (One of those problems is HUD itself -- see below.)

This still doesn't begin to deal with the issue of how much subsidy is enough and how much profit is appropriate. With respect to developer profit, it is certainly understandable that a government which is giving away taxpayers' funds to try to achieve a social purpose would want to maximize use of those funds. Maximization means avoiding a windfall to anyone in the process. By definition, the person receiving the windfall would have performed his role in the process for less and the difference could have been used for the social purpose.

On the other hand, government programs which depend on the private sector must build in enough profit to induce the private sector to participate. The pendulum tends to swing between windfall and insufficient incentive. In the last year -- thanks largely to Congressional hearings and media reports -- the pendulum has swung very rapidly from (alleged) windfall to insufficient incentive. It is still moving and may continue until, literally, it hits zero. For some, this means that all low income housing development and ownership should be non-profit. Since public ownership was tried and for the most part has failed, these people would rely on the private non-profit sector, largely community based non-profit housing development corporations, and on larger non-profit funding and technical assistance groups to help them.

I have been partners with some of these groups. I have the greatest respect for their dedication and in many cases their expertise and effectiveness. But I do not believe that they can do the job without the significant participation of the private for-profit sector.

Twenty-five years ago, a top Federal housing official said that the only way to solve the low income housing problem in America is to harness raw greed. I believe that is still the case today. That means that you design your government programs to reward the developer who contributes to your goals -- he cannot make his profit unless he produces the housing the elected representatives decide is needed. But if he does do the government's job -- the job the government has substantially failed to do itself in the 50+ years since the Housing Act of 1937 -- then he has earned his profit. If he didn't think he had a chance to make it, he wouldn't have participated. If his benefits are retroactively withdrawn -- if the agreement is broken by the government -- at some point he will probably decide there are better ways to make a living and won't participate even if the government says "I've got a new program -- trust me this time." In case anyone thinks the government would not change the rules in the middle of the game, I would suggest that the Tax Reform Act of 1986 and the moratorium on FHA mortgage prepayments are just the most prominent of many recent cases of Congress and HUD reneging on their promises.

In any case, the incentive issue applies to private non-profit developers as well. As funding sources for CDC's and other non-profit developers become more and more scarce -- especially government sources -- non-profit developers must look to a greater extent to profits from development in order to fund their staff and seed money needs, as well as other non-income producing goals that all such groups have. Underfunded non-profit developers cannot move quickly to purchase deteriorating buildings in their neighborhoods, take advantage of sales of tax delinquent properties, provide board-up and maintenance for their undeveloped building inventory, or properly insure their buildings. They also cannot attract and keep good staff, people who must be knowledgeable about increasingly complex legal, tax, accounting and financial issues, design and construction methods and costs, property management, community and tenant relations, fund raising, management, etc.

One final point on incentives. As a young man studying economics, it always seemed to me that socialism made a lot of sense, especially as a way of avoiding the grinding poverty for some that so often seems to be endemic to capitalism. What bothered me was the many socialists who seemed to be much more concerned that some people might be too rich than that other people were too poor. Similarly, on the subsidized housing issue, there are too many who are so concerned about windfalls that they would rather see more people ill-housed and homeless than take a chance that someone will get "too rich" housing the poor, whatever their definition of "too rich." The irony is that this category now encompasses both a substantial number of so-called housing or tenant advocates and conservative, business oriented top level administrators of HUD.

In December of 1989, HUD allowed tax credit funding to expire for projects throughout the country seeking HUD subsidies -- more than 50 projects by some counts -- rather than make a decision to fund those projects and be subject to second guessing by Congress and the media as to whether the subsidy allowed excessive developer profits. A lot of families will suffer from that decision, but since they aren't well organized and most of them don't even know who they are, HUD seems to be vindicated in its assessment that it would be more at risk in approving these projects than in letting them die. Ironically, Congressional hearings designed to expose abuses in HUD programs meant for poor people have resulted in termination of almost all HUD multi-family programs for low, moderate and middle income tenants instead of reform of those programs.

All this still begs the toughest question -- how much profit is enough? Congress charged HUD and 50 state agencies with answering this question when it passed the 1989 Housing Act and the 1988 amendments to the low income housing tax credit. Unfortunately, there probably is no satisfactory answer. Despite the windfall profits allegedly available in recent years, the number of for-profit developers in the subsidized housing business has dropped precipitously. Obviously, this is largely a result of the reduced levels of Federal funding. But it is also a reflection of the view that the difficulties and uncertainties of developing subsidized housing today are not adequately compensated by the potential profit.

Because of the reduced funding, greater neighborhood empowerment (translation: we can organize to keep low income housing out of our community), increasing environmental and hazardous waste problems, etc., the average size of subsidized projects has fallen significantly. This, too, has reduced developer profits, since in most cases a small project takes just as much time and effort and paperwork as a large one. The only saving is in the amount of capital at risk on average, but that is partly offset today as the number of funding sources per project increases, which tends to increase the time for which capital is at risk as well as the risk that one or more funding sources will fall through and the capital will be lost.

In Chicago, for instance, from the late 1960's to the early 1980's there was a very active subsidized housing sector, with a number of private for-profit firms devoting most or all of their organizational efforts to the development of government subsidized housing. Many of those firms are now gone or at least entirely out of the subsidized housing business. For those who are still developing subsidized housing, it is no longer the major part of their business.

The same expertise that can build subsidized housing can build middle or upper income sales or rental housing, office buildings and shopping centers. In fact, all of those products are much easier to develop than subsidized housing -- the only thing that is tougher about them is the marketing. For a developer who meets the marketing challenge, or who passes the risk on to lenders or investors, the profit potential is significantly greater.

A. Sales housing: A developer who creates 200 homes or condominiums at an average price of $100,000, a $20 million project, would expect a profit in the range of 15% or even 20% of total project costs, i.e., $3 million to $4 million.

2. Shopping centers: A shopping center developer may project that after a successful lease-up, the permanent mortgage will cover all costs and cash flow of $2.00 to $3.00 per square foot per year will still be available. In addition, the developer can profit from developers' fees, leasing fees, management fees and residual value. Successful, prominent regional shopping centers sell at

much lower capitalization rates than any kind of housing, let alone low income housing.

3. Office buildings: Office building developers also benefit from cash flow and the same variety of fee sources as shopping center developers. In both cases, developers can limit or even eliminate their own risk by joint venturing with institutional investors. These investors are not interested in low income housing. Projects can range in size up to $100 million and above with commensurate profit potential. Subsidized housing projects today -- especially new construction -- tend to be a fraction of that size.

Just as developer profit opportunities are greater in other areas of real estate, so, too, it is hard for low income housing developers to compete for talent. We are competing not only with developers of market rate real estate, but we are also competing for the most capable lawyers, accountants, financial analysts and others whose skills would be useful in fields other than low income housing:

A. Investment banking: I would guess that low income housing developers would be satisfied to be compensated by the standards of the industry that the FHA Commissioner knows best. A recent newspaper article indicated what a tough year it had been for investment banking, what with bonuses being cut and all. An accompanying chart listed typical salaries at different firms ranging from $160,000 to $180,000 per year. A close look at the small print, however, made it clear that those figures were for second year employees. Apparently, more senior employees receive compensation ranging up to the $500 million per year which was earned by the head of a firm who created a method of financing which has been argued by many to be contrary to the best interests of the economy and the country. (And that was the legal stuff.) One might argue that developers of subsidized housing, carrying out government policy, should be better compensated than investment bankers.

B. Syndicators: The skills required for this business overlap with those required for real estate development and low income housing. In fact, low income housing tax shelters have off and on been one of the more significant products syndicated. A number of Chicago firms have made a remarkable success from this business of using other peoples' money. These are basically small operations -- like low income housing developers. They are not Fortune 500 companies, but in a number of cases they are owned by Forbes 400 individuals. Neither list includes any low income housing developers of whom I am aware, unless they got there in spite of, rather than because of, their low income housing development successes or failures. (I am aware of both syndicators and developers who started out in low income housing and made a great deal of money after leaving the field.)

C. Real estate developers: See syndicators, above. In the early 1960's, a young man with whom I later became friends applied for two jobs. After deliberating carefully, he chose the job with the office building developer over the job with the low income housing developer. A year later, I took the low income housing job. I'm glad I did, but while still at a young age he was able to use his office building development profits to purchase two of the most prominent magazines in America, and he didn't have to seek out partners to help him raise the money.

D. Mortgage bankers, real estate brokers, *et al*: Fortunes have been made in mortgage banking and ownership of real estate brokerage firms. A young person starting out in brokerage, if successful, can make far more money far quicker than working as a staff person in development.

E. Law firms: The top firms even in Chicago now pay $70,000 to $80,000 as starting salaries to law school graduates with no experience. Presumably, this escalation in salaries was driven by investment banking salaries (see above). We have to either compete for our own staff lawyers against this salary schedule or, worse, we have to pay outside lawyers who have to make a profit on these people.

Our own organization is small, even though we are probably one of the largest low income housing developers in the Midwest. It consists of three partners, two of whom spend a minority of their time on development of new projects and a minority of that time on development of low income housing. In addition, there are four staff people at the professional level. There are four support people in the office, but three of them spend probably no more than 20% of their time supporting the development staff. In addition, there are two or three people at other loosely affiliated companies (property management and mortgage processing) who can be called upon for advice or assistance from time to time. This is really the entire development organization. But I consider real estate development to be a rather sophisticated and demanding endeavor. In terms of educational background, our three partners number among them two law degrees, a masters degree in public administration and a Ph.D. in economics, as well as considerable additional graduate work. The four professional staff include two masters degrees in architecture, two additional masters degrees, including one in social service administration, and a law degree. All three partners and two of the four support staff have more than 20 years experience in the low income housing or closely related fields. The two people in the related companies most likely to be called upon both have MBA's and close to 20 years experience in low income housing. Almost all of the degrees referred to above are from schools considered to be "elite."

With this array of talent, only one of the three partners even draws a salary, and none of the professional support staff earns more than $65,000 per year. Changes in the tax laws, among other things, have made staff equity participation in development projects pretty much meaningless. Yet we consider that we pay better than most firms in our business, and far, far better than non-profit housing development corporations of which I am aware. But compare this compensation to what is being paid by other firms with which we have to compete for job applicants.

If the structure of the low income housing development industry, consisting of a fairly large number of quite small companies, cannot compete for talent under present conditions, is there a better way? From time to time, it is suggested that large corporations can solve our low income housing problem. History refutes this thesis. From the late 1960's to the late 1970's, big corporations did get into the business for a variety of reasons. Boise-Cascade and Inland Steel come to mind. Basically, they lost about as many tens of millions of dollars as they were willing to invest in the program.

So if the government wants the private sector to participate in providing affordable housing, it must offer incentives which are in some degree competitive with what the developer can make by doing something else, and which allow the developer to attract competent staff. But what should the developer be compensated for?

1. Opportunity cost. As described above, the developer could presumably be making money doing other things. Or, he could be providing his services for a fee -- say to an institutional investor/developer, a government agency, etc. See above for how much he could make.

2. Overhead. The developer has to pay his staff, office rent, office machine leases, etc. Even figured at the developer's out of pocket cost as opposed to the value of the services his staff might bring on the market, the numbers can be substantial.

a. Last December, as a condition of receiving HUD subsidies, we were, in effect, required by HUD to calculate our overhead in a pair of adjacent deteriorated projects which we intended to acquire and rehabilitate. We estimated that from inception of the project to completion of rehab, our development team would have $415,000 of overhead in the two projects (much of the work applied to both). This doesn't count the next 15 to 30 years for which we have obligations, nor does it count for time spent on legal, marketing, management or construction issues, for which separate compensation is provided. And these projects involved only modest rehab of less than $10,000 per unit on buildings 10 to 20 years old, not substantial rehab of older buildings.

b. In the last few months, we completed a project that already had a Section 8 allocation in 1983. The project was first conceived and work started in 1982, initial closing took place early in 1988 and the project was completed by late 1989. Final closing will be in 1990, capital contributions will continue to be received until 1993 and our guarantees on letters of credit will remain for at least two or three years beyond that. In other words, our profit will be deferred by as much as 13 years from the time we first started to incur our overhead expenses and make our advances to the project. This may be unusual, but with a typical five year pay-in period for capital contributions, an eight year deferral is not unusual.

c. Why does developing subsidized housing take more overhead over a longer time and why is there a greater risk that it won't get done? Here are just three of the reasons:

i. Local opposition. In all but the worst neighborhoods, there tends to be fierce opposition to any government assisted housing. Such projects almost always need at least some government approvals, and most projects need several government approvals. Elected officials tend to support strongly held views of constituents, especially where there is no organized block of constituents on the other side of the issue. The result is that many subsidized housing possibilities never see the light of day, and many proposed subsidized housing projects drag on for years before the developer, after incurring heavy costs of meeting after meeting, hearing after hearing, redesign after redesign, option extension after option extension, financing extension after financing extension, updated projection after updated projection, and redrafted legal document after redrafted legal document, finally is forced to give up.

ii. The shortage of subsidy funds has created a new phenomenon which is also very costly to the developer in the risky pre-development phase of a project. In order to make the numbers work, the developer must combine assistance from a variety of sources. All have to be in place at the same time to close. Each wants to know that the others are in place before committing.

And it's getting even more complicated. In addition to the more traditional federal, state housing agency and local government sources, Illinois and Chicago, like a growing number of state and local governments, have housing trust funds recently created from real estate transfer taxes, linked development fees and other sources. There are also banks, other lenders, utilities and community oriented corporations which lend to or invest in lower income housing either individually, or, in a growing number of cases both nationally and locally, in the form of a pooling of funds with a single staff to administer the funds. Each funding source is, of course, anxious to justify its existence by showing a record of great accomplishment compared to its funding commitments. The way to do this is to invest as little as possible in each project but still participate.

In other words, if one of these entities has $1 million to spend and puts it all into one project to create 20 apartments, all they can show on their annual report is 20 apartments. So they say to each applicant "We'll give you $200,000 to put you over the top if you can get $800,000 in some combination from HUD, the state housing agency, the local housing trust fund, your city's department of housing, local corporations and syndicators." They can find five applicants this way, make five different groups happy, and write an annual report that takes credit for 100 apartments instead of 20. Four other funding sources do the same thing and it looks like 500 apartments were developed when in reality only 100 apartments were developed. This would be relatively harmless if it didn't make the developer's job approximately five times as difficult and a lot more costly. (Of course, it also multiplies the staff and legal and consulting costs of the funding sources.)

iii. Availability of raw land/contiguous sites. With the demise of federally financed urban renewal, it is extremely difficult to obtain large vacant tracts of land for low income housing. The developer must concentrate on smaller scattered site projects. Scattered site development carries higher costs for construction coordination and security. Each site must undergo the same inspection by local building authorities, and unforeseen construction problems are widely varied from site to site. Each site is a project unto itself.

3. Capital. Twelve years ago, we did a project with no cash advances prior to initial closing -- only a $10,000 refundable earnest money deposit on the land. The project closed less than six months after we started working on it. But this was possible only because the project was a clone -- we put a "II" on the working drawings for an earlier project on an adjacent parcel. As described above, we have also gone six years between inception and initial closing, and we have been the consultant on projects which took even longer. During that period prior to initial closing, invested capital (seed money) is at very high risk. You don't know that you will ever close until the note is actually endorsed by the FHA Commissioner. The developer cannot afford to have too much tied up in any one project or, in most cases, he is effectively out of business. The biggest expense is if options on land or buildings run out and the land has to be purchased. The architect is also a very significant up-front commitment. Third, commitment fees for financing, and other lender or mortgage insurer charges, can be substantial. Also, environmental studies (and curing hazardous waste and asbestos problems); legal fees for a variety of purposes; the costs of obtaining zoning, permits and other government approvals; feasibility studies and appraisals; and accounting fees, especially for projections, also contribute to the amount of high risk money required for a new development. So, in additional to overhead, developers can incur costs for a subsidized housing project ranging from zero to a million dollars or more before financing is secured. The costs are similar to other kinds of real estate development, but the time frame from inception of the project to initial closing tends to be longer, and the risk of the project dying somewhere along the way is greater.

4. Guarantees. In addition to actual cash advances, the developer may be responsible for a variety of personal guarantees,

covenants, representations and warranties to lenders, investors and government agencies during the development period and in most cases well beyond:

a. The developer will probably have to guarantee completion of the project to the investors and possibly the lender. The guarantee will probably be open ended. One bad project can break a developer stuck with a completion guarantee.

b. Rent-up guarantees will probably be required by investors.

c. The developer will almost always have to guarantee against negative cash flow -- the guarantee may or may not be limited with regard to time or amount.

d. The developer may have to guarantee that the project meets all applicable government codes, probably even those passed after the date of the guarantee.

e. In some cases, the developer may have to guarantee tax consequences, including qualification for historic and low income housing tax credits. This is particularly risky in dealing with new and frequently changing tax laws for which complete regulations are not issued until years after the laws are effective.

f. In some cases, the developer may guarantee cash flow.

g. Increasingly, developers are required to give guarantees against hazardous waste liability.

h. Some or all of these guarantees in a particular project may have to be secured by cash escrows, letters of credit or other forms of security. This can tie up a developer's credit and seriously limit his ability to initiate new projects or rescue his own troubled projects.

5. The developer's profit on successful subsidized housing projects must cover overhead and expenses on losing projects and projects which never got to the start of construction. This is the same as the salesman or broker whose commissions have to make up for the unsuccessful calls he makes, the manufacturer whose profit must cover research on products which never get to market, or the architect, contractor or developer who submits proposals in a competitive bidding situation where there is only one winner. As described above, these costs can be substantial.

6. In order to better appreciate what the developer's profit and overhead (or developer's fees, or whatever other name is used) has to cover, the following is a description of the process that we went through to create one of the first low income housing tax credit projects, which was completed about a year ago. From 1961 to the early 1980's, this project could probably have been done with a HUD insured mortgage and a HUD subsidy which was part of the mortgage until 1972, or separate but closely related thereafter.

Essentially, one stop shopping for the financing. This is what it took in the mid-1980's:

a. Create a joint venture between a non-profit developer and a for-profit developer. This is more often than not a long, tough negotiation with considerable paperwork and the project may never get past this step. We had done two previous projects with this non-profit, so in this case the arrangement was not a major problem.

b. Option four different properties because government policy favored scattered site projects. With each delay, four different extensions had to be negotiated. Additional legal fees were incurred. Eventually, a couple of the properties had to be purchased because the sellers could not or would not give additional extensions. Also, the price of extension in some cases was an increase in the cost of the property. One building was lost because the neighborhood had convinced the alderman to oppose it and his opposition would have eliminated the possibility of a City loan. This building had to be replaced, which required reprocessing of all loan commitments. Periodically, we had to go to building court to forestall demolition of the building by the City.

c. Section 8 mod rehab assistance was obtained, extended and revised through the pre-development period.

d. We processed and obtained an FHA commitment to insure the maximum Section 221(d)(4) mortgage that could be supported by the Section 8 rents. However, we were rehabbing very large units for large families -- the type of housing for which there is the most need and the least production. The HUD loan could not cover the necessary costs.

e. Therefore, we obtained a loan from the City of Chicago Department of Housing (DOH), which agreed to loan us either CDBG or Rent Rehab funds from HUD. We had a long, difficult negotiation with the City as to repayment terms, security and other issues, reflected in extensive legal documentation by the City's corporation counsel. The DOH commitment had to be approved by a vote of the City Council of the City of Chicago. DOH also had to comply with complicated HUD regulations for the use of CDBG and Rent Rehab funds.

f. We had to negotiate a construction contract with a third party contractor who could bond the job and agree to meet HUD requirements regarding affirmative action and prevailing wages, as well as our non-profit partners' requirements for local hiring and use of local subcontractors. Such contractors are particularly hard to find for small projects, which require sophistication beyond the level of a small contractor but are too small for a large contractor.

g. We had to negotiate a commitment from the Illinois Housing Development Authority to fund our mortgage from tax exempt bond funds and to administer the HUD Section 8 contract.

h. On some of these projects, our non-profit partner had to negotiate a loan from a source such as the Local Initiative Support Corporation (LISC) to carry them through the long development period.

i. We had to negotiate letters of credit from a local bank to secure certain of our financing commitments.

j. We had to provide for a relocation plan for any tenant who was in occupancy in any building at the time we first acquired our option. The plan had to meet federal standards, with the cost shared between the City and ourselves. The City's money came from HUD, and had to comply with their rules.

(By and large, each HUD program and each set of HUD rules and regulations applicable to our project was administered by different HUD personnel, often with little or no coordination.)

k. We had to pay for an asbestos inspection and then remove asbestos from all four buildings before the start of construction. Our architect refused to even write a specification for the removal, and the general contractor would not start until the asbestos had been removed. A year later, either lenders or investors would have required a full scale environmental report and a plan for dealing with hazardous waste problems.

l. If we had known in time that federal low income housing tax credits would be available, we would have dropped the IHDA financing and used taxable financing arranged through a different mortgage company (not our HUD processor) and would have had to meet GNMA and lender requirements for GNMA mortgage backed securities.

m. After a couple of years' work and a substantial investment in options, architecture, etc., we found by the summer of 1986 that the tax benefits we had been relying on to sell equity to limited partners would be unavailable under the Tax Reform Act of 1986, which by that time looked like it was sure to pass. A subsequent change in the proposed law allowed the used of low income housing tax credits instead of tax losses, so we applied to the City and IHDA for credits pursuant to undefined rules for this new program. We finally did syndicate with a public fund for less than we had expected to get for the losses under the old law. The fund paid us between 35¢ and 38¢ on the dollar for the credits. The public fund requires us to submit quarterly reports in a form suitable for meeting their SEC reporting requirements. We spent a lot of money on accounting and legal fees trying to figure out how to comply with IRS requirements for a section of the Code for which regulations did not (and to a large extent still do not) exist.

n. Because of the Section 8 assistance, we didn't have to worry about competitive marketing of the apartments when they were finished. We did have to comply with federal, state and city guidelines for tenant selection (including devising and implementing a fair system for allocating the apartments among the long list of those tenants who wanted them), HUD affirmative marketing requirements, new HUD rules for priorities for Section 8 apartments, non-discrimination laws which now encompass not only race, religion, age and sex, but also new requirements relating to the handicapped and families with children (which are much more complicated and with more far reaching consequences than legislators are likely to have imagined), verification of tenant incomes and computation of the proper rent to be paid by each tenant, since each tenant pays a different rent. We also had to enter into an agreement with the Leadership Council of Metropolitan Open Communities which obligated us to accept a number of tenants from the Chicago Housing Authority waiting list pursuant to the Federal Court decree in the Gautreaux case.

o. We had to negotiate a contract with our architect which met HUD rules and then develop with him a rehab plan meeting HUD minimum property standards or the currently applicable equivalent. There are issues, such as bedroom count, minimum room sizes and dozens of others where the decision a conventional rehabber would make would not be right for a government assisted project.

p. We had, of course, the other normal real estate development issues to deal with: construction, design, energy efficiency (although HUD also has rules on that), zoning, access to utilities, etc.

So that was what we had to do to upgrade thirty (30) deteriorated and mostly vacant apartments to meet codes and make them habitable and yet keep them in the low income housing stock. We were very pleased with the end result, but I would suggest that this amount of time, effort, expense and public - private - nonprofit cooperation to produce 30 apartments is not a national model for solving the shortage of low and moderate income housing or saving our deteriorating housing. Nor is this a scale of development which can support adequate compensation to developers.

In order to evaluate the appropriate profit for development of a low income housing project, it is necessary to review the major sources of profit to a developer of market rate housing:

1. Development fees and/or profit equal to the excess of funds raised over the cost of the project.

2. Leasing fees.

3. Management fees.

4. The value of the equity:

   a. Cash flow.

   b. Tax benefits.

   c. "Residual," i.e., profit from sale or cash distributions resulting from refinancing.

Based on the new low income housing tax credit provisions, these sources of developer compensation are affected as follows:

1. Administrators are mandated to limit developers' fees and up-front profit.

2. Leasing fees. Some government loan programs provide modest funds for the initial setting up of the management and leasing of the project. Otherwise, there is no separate fee or commission paid for leasing at all. The leasing is not subject to the competitive marketing stresses of market rate real estate, but there is a very substantial administrative and paperwork burden not only in the initial leasing but also in annual recertification of incomes.

3. Management fees. Management fees are regulated and limited by state agencies and HUD. My own impression is that there are very wide differences in the administration of management fee limitations around the country, as well as a failure in many places to recognize the difficulties and cost of managing very small projects, scattered site projects, low income and inner city projects and other special situations.

4. Equity:

a. Cash flow: There is usually little or no cash flow to the developer even if the project is able to generate cash flow.

   i. Distribution of cash flow is limited -- usually by statute, but in any event by the level of subsidy available or by limitations on the income of tenants and therefore on rents.

   ii. Some or all of the cash flow may be committed to lenders, especially lenders of "soft" second mortgage loans who participate in cash flow.

   iii. Whatever remains generally goes to the (low income housing tax credit) investor limited partners.

b. Tax benefits: Generally 99% of all of the tax benefits go to the investor limited partner, leaving, at most, a negligible 1% for the developers.

i. In any event, no individual can use more than about $8,000 per year of tax credits.

ii. For individual developers or corporations which do not have passive income, the tax losses, which have traditionally constituted a significant part of the return from real estate, cannot be used. Essentially, there is now no market for such losses.

c. "Residual"

i. The low income use period is extended to 30 years. A cursory study of present value tables makes it clear that almost any projected value of the equity 30 years from now has a negligible present value today.

ii. The only way to avoid the 30 year use restriction is to offer the property to the tenants after 15 years. The developer gets the benefit of the residual only if the tenants don't buy, i.e., only if it isn't worth anything.

iii. The formula sale price to the tenants gives the mortgagor partnership a modest return on investment (not to exceed 5% per year). Pretty much by definition, all of that goes to the investor; nothing is left for the developer to share.

Thus, any assessment of the appropriateness of the amount of developers' fees for low income housing must take into account the fact that other traditional sources of developers' compensation are severely limited, although the obligations and liabilities of the general partner continue for many years into the future.

A structure for determining profit should encompass at least the following elements:

1. Overhead: A reasonable allowance, or an accounting of actual cost, for each project. A simple percentage of something is probably not adequate. What would be the base for the percentage? Total project cost? Value added? Should there be a different percentage for acquisition cost vs. improvements? Would it take into account the number of financing sources? The complexity of the ownership and financial structure and/or the government programs involved?

2. Profit: The same questions apply to profit. Should it be a percentage of something or a number of dollars per unit, per square foot or per project? Does it make any difference whether it is rehab or new construction? Should profits be higher for something you want to encourage, e.g., rehab, or lower government subsidies per unit compared to equity?

3. Return on cash at risk: Since this is capital at high risk, it presumably deserves a high return. How would developers be discouraged from choosing to put more funds into the project at a certain point just to earn the high return? Does it matter how long the funds are at risk, or is that covered by a single rate of return based on the passage of time? Does it matter whether the funds were borrowed and if so at what rate?

4. Guarantees: A return for guarantees made and security posted for guarantees would be appropriate since this is surely a critical element for developers. A project in which the developer earns a developer's profit or fee of $500,000 and neither lenders nor investors nor governmental agencies have any financial recourse against him is dramatically different from a project with the same development profit where the developer has personal guarantees, and may have posted security, for $1 million for periods of three, five, ten or even fifteen years.

But if guarantees are taken into account, how do you distinguish between a guarantee from a shell corporation and a guarantee from a wealthy individual? Between a guarantee from a wealthy individual, an ambitious, qualified young individual with little or no net worth and a "straw man" with little or no net worth? Between any of these and a well established neighborhood housing and economic development corporation dependent on foundation and government grants from year to year for its continued existence? If you treat them all the same, the potential for jacking up the allowable profit without real additional risk is obvious.

5. How do you distinguish between one-man development organizations with all functions contracted out to others, e.g., mortgage processor, lawyer, accountant, feasibility analyst, architect, cost estimator, etc., and developers who do the whole thing in-house and therefore incur far greater overhead? Or should the outside, arm's length fees paid by the one man developer have to come out of his profit? Which fees would these be, and which ones would not be chargeable against his profit, e.g., architecture?

6. How high the upside should be allowed to go depends partly on how low the downside can go. Public utility rate making concepts would be applicable here. If the government is willing to cover cost overruns and give some guarantees as to cash flow and residual values, then compensation should be limited to overhead plus a return on invested capital plus a modest profit percentage. To the extent that the developer's downside is unlimited (e.g., an open ended completion guarantee), a higher profit is justified. (How is the profit issue dealt with in national defense contracting?)

7. If government is going to regulate profits, at some point rules have to be adopted, and these rules will not be fair in every case, but will presumably strike an average. Thus, there will still be "excessive" profits in some cases and "inadequate" profits in others.

These are some of the reasons why profit is an element of cost best left to private markets for determination. However, if you have to have a fee or profit schedule, perhaps the following is a reasonable starting point, to be tested out by application to a variety of prior, proposed and hypothetical projects to see whether the results make sense:

a. Create a fixed floor for overhead on a dollars per project basis, then lump the remaining overhead together with profit as a percentage of cost since risk and responsibility do tend to increase with project costs.

b. The lump sum for overhead should be $100,000 for project acquisition, and $100,000 for improvements if there are more than 50 units and greater than $8,000 per unit of rehab. (Below these cutoffs, all overhead for improvements would have to be covered by the percentage.) Cost certification of actual overhead on a project by project basis, while more fair, would be an undue administrative burden on the developer and the regulating agency, and could also reward inefficiency.

c. Provide a percentage, say 4%, of acquisition costs, as an acquisition fee. There should be a minimum base for acquisition in the amount of, say, 50% of the current reproduction cost. This would make the fee schedule reasonable for older projects in bad condition, e.g., a 20 year old non-profit Section 221(d)(3)BMIR which is in default in a drug-infested inner city neighborhood. The purchase price might be $1.00 over the $10,000 per unit remaining mortgage balance, yet this is a project which should command a maximum fee to the developer who can successfully turn it around.

d. Use a profit and overhead figure of 13% (which happens to correspond with the identity of interest subcontractor profit and overhead of 10% and 3% allowed by HUD) of the cost of improvements (both hard and soft cost). There is more expertise, effort and risk involved in development than in acquisition.

e. Like the HUD architecture fee schedule, the acquisition and profit and overhead percentages could be reduced on a sliding scale as the acquisition cost or the rehab or construction amount go up. The overhead and risk do not go up quite as fast as the size of the project.

f. An extra percentage could be awarded if the property has had negative cash flow over the last three years or the mortgage is in default under prior ownership for at least a year. Or there could be a bonus for developing in certain low income census tracts. There are endless possible variations.

g. Perhaps the profit should be deferred to some degree over the years for which the developer will continue to have an obligation and responsibility.

h. The allowable return on advances to the project should be at a rate commensurate with the risk, e.g., 20% per year, or double the prime rate.

i. The return on guarantees has to be at a rate low enough that the developer, whether overly optimistic or not, is not encouraged to make additional guarantees just to earn the additional return. Perhaps something like 5% per year where the guarantee is secured by letters of credit, marketable securities or other good collateral and 2½% where the guarantee is unsecured. Query about an open ended guarantee?

j. If profit is going to be regulated, there will have to be a cost certification procedure similar to that required for HUD mortgages. Perhaps developers could be allowed an extra profit, if earned over and above initial estimates, to offset earlier projects for which cost certification showed that allowable profits were in fact not earned.

The question of how much subsidy is really not very difficult once the profit question is determined. The amount of subsidy is backed into by adding up the costs and expenses, subtracting the amount of income that the targeted group can afford, and subsidizing the difference. If you do less, there aren't any projects that are feasible. You would not have to do more.

The truth is that if the Congress does not appropriate more money to subsidize housing production, the amount of profit allowed to developers will be pretty irrelevant. The demand for the funds will be greater than what is voted no matter what the profit limitation is. However, the lower the profit allowance, the less likelihood that those who apply for the funds will be capable of successfully producing and operating low income housing.

My own bias is toward Federal funds for housing production and for rent subsidies, because that is where the taxing power is. And HUD should administer those funds. But the Federal government cannot accomplish anything meaningful in the low income housing area without improving HUD as an agency. My subjective assessment is that HUD has suffered a serious deterioration of personnel in the last ten years. Twenty years ago, HUD had intern programs which attracted the best and the brightest, people coming out of top undergraduate and graduate programs across the country with a desire to solve the problems of our urban areas. They went to work for HUD, and did a capable job of furthering program goals despite their initial inexperience. Most of those who had stayed on at HUD left early in the Reagan administration. Other knowledgeable and experienced HUD staffers reached retirement age. Neither group has been adequately replaced, and many have not been replaced at all.

The reason for the deterioration on the part of HUD staff has been, I think, well explained by Senator Harkins. He suggests that a company whose owner denigrated the employees of the company and said publicly that what they were doing was not worth doing would not be able to keep its good employees or motivate the remainder. For the eight years that he was the HUD boss, the posture and public pronouncements of Ronald Reagan mirrored those of the hypothetical owner. Although the current Administration has toned down the negative rhetoric, its actions reflect a similar attitude.

In addition to the staff deterioration, the top level appointed administrators at HUD have been people who basically did not believe in the programs and for the most part had no housing or urban development background. Since they did not believe in the program goals, it really didn't make any difference who got the subsidies -- they might as well go to friends of the administrators who would directly or indirectly return the favor. Congressman Barney Frank described the situation properly, I believe, when he said that there are always pressures from developers and their consultants to have their projects approved. When the system is working right, agency personnel fight to keep the programs from being subverted, although they are open to valid arguments from developers and their representatives. In the Reagan administration, there was no one at HUD pushing back. Since the pressures on HUD continued or even increased due to the ever diminishing funding, the result was the mod rehab "scandal."

(Incidentally, estimates of the much publicized losses at HUD due to mismanagement and perhaps even criminal violations put the loss at about 1% of the various estimates of losses to the Federal government because of savings and loan industry fraud and excesses. The purposes of S & L's was, at least at one time, to house middle income Americans. HUD's mission is serving low and moderate income Americans as well as other groups.)

At this time, HUD appears to be too scared to act. This means there will be no production. The Congress put HUD on the hook, they now have to somehow get HUD off the hook if they really want anything to be done in the housing area.

What HUD and the private sector developer did not need was a 1989 Housing Act which superseded what would have been the first real housing act in many years, and consisted primarily of a list of fines for people who wanted to participate in HUD programs (or people who are pretty much stuck with continuing to participate). HUD somehow convinced the Congress that even though HUD powers already included debarment, criminal prosecution and restoration of funds taken improperly, the problem was that HUD did not have sufficient deterrent powers to prevent malfeasance by owners.

Nor will HUD be turned around by a deceptive capital gains tax reduction which takes back from real estate sellers almost as much as it gives them; IRA breaks which will help a family to generate about $1,000 in five years toward the purchase of a home; sale of public housing units to their inhabitants (don't the poor have enough problems without adding the burdens of home ownership -- especially the worst homes in America?); or enterprise zones (which at best -- when effective -- apparently just move economic activity from one location to another at significant cost to the government).

The long term solution is giving HUD the authority, the funding and the moral support from the Administration and Congress to enable HUD to regain its old idealism and enthusiasm, and thereby attract more competent and more dedicated staff people.

/wtb

Senator **GRAHAM**. Thank you, Mr. Baskin.

Mr. Clancy.

STATEMENT OF PATRICK E. CLANCY, EXECUTIVE DIRECTOR, THE COMMUNITY BUILDERS, BOSTON, MA

Mr. **CLANCY**. Thank you, Mr. Chairman.

My name is Patrick Clancy, executive director of The Community Builders, a nonprofit organization which has developed 5,000 units and has another $100 million of affordable housing in construction, and another 2,000 units under development.

I'd like to comment today by mentioning four elements.

First, an historic overview of what this committee is considering.

Second, the make-up of the private sector today.

Third, some thoughts on levels and measurements of incentives.

And, fourth, some critical priorities.

First, the question that you are asking, what's the right incentive and the right profit level, is the right question. It is, however, a question which has not been asked over the last 20 years of Federal housing engagement. We've had for 20 years a system where the Federal Government is providing both direct incentives through HUD, through various forms of subsidy, and investment incentives available through the Tax Code.

For 20 years, affordable housing production has meant utilizing both of those resources and virtually no low-income housing has been produced that has not utilized both investment incentives and direct expenditures.

Nonetheless, HUD, for the last 20 years, with the sole exception of the UDAG program, in all of their housing subsidy programs and in all of their mortgage insurance programs, has looked only at the direct expenditure side of the equation.

They've been aware that there is another world out there, but they have not had it within their purview. They have had no understanding within the whole structure of HUD of what investment incentives are, what they amount to and how they work.

Congress has often, in passing tax incentives, thought that they were going to stimulate affordable housing production separate from direct subsidy programs. In 1969, with the 5-year write-off of rehabilitation expenditures, the discussion of the economists here on the Hill said that provision would stimulate low-income production without direct subsidy from HUD. It never did.

In 1986, when the low-income housing tax credit was passed, Joint Tax Committee staff were convinced that it would produce low-income housing separate from direct incentives from local, State or Federal government. It hasn't and it won't.

We've had a dual system where both kinds of incentives have to be utilized for 20 years. We've had a HUD that's totally unaware of tax incentives and how they work. We've had a Treasury that doesn't understand housing programs and how they work.

Those of us in the industry, at least a number of us in the industry, have been saying for a number of years:

Put the two together and look at them together.

That's what you are now coming to in your discussions as a committee, and you're to be applauded for doing that.

The right question, though, is not can we combine these resources because, in fact, we need to combine them. We always have. And unless you do a much more extensive subsidy, either directly or through the Tax Code, we will for the indefinite future.

The question isn't can we or should we be able to combine these resources, but let's look at the total envelop. Let's look at all the resources. Let's look at all the costs. Let's figure out how we design an incentive structure that maximizes what those resources are getting for us in terms of public benefit.

What is the private sector today that needs to be incentivized, if you'll let me make a verb out of a noun, which is not a good practice.

What is the private sector that we want to try to incentivize to create affordable housing?

That private sector has evolved a lot over the last 20 years. We have gone from a world of conventional commercial builders who, as a part of what they did, did Government-assisted housing, to a world of a much more highly specialized subset of the for profit development community that knows, understands and lives with the various ins and outs of various governmental programs, how to use them and how to access the money available under them.

As those resources have diminished, the scale of that sector of the real estate industry, that is, the for profit side that is doing affordable housing, has continued to diminish.

At the same time, we've seen a dramatic growth in the nonprofit sector from a few church groups and union-affiliated housing organizations 20 years ago to a level where, in cities such as Boston, more than half of the affordable housing being produced today is being produced by community development corporations in the nonprofit sector.

The nonprofit sector has a lot to offer, providing a kind of marriage of public purpose with private entrepreneurial activity that can minimize some of the conflicts that this committee is looking at.

By the same token, I want to completely agree with what Sheldon Baskin has said and say that if we are going to make a serious attack at the need for affordable housing, we need to engage as much of the real estate industry, for profit as well as nonprofit, in creating affordable housing as we possibly can.

Or that attack, if it relies only on nonprofits or if it's too constricted, will fall far short of the needs.

How much is enough?

Excess profits are kind of like pornography. You know them when you see them, but I'm not so sure it's easy to define them in advance.

I'd like to propose a kind of definition that talks about some of the elements of that definition. Incentives for affordable housing must be designed so that they provide first coverage for anticipated and real overhead, staff time, the time value of money and a wide variety of other direct out-of-pocket expenditures.

Second, they need to provide a reasonable margin of safety for developers, funders and lenders.

And, third, they need to provide an ultimate return potential that is sufficient—and here's where it gets a little complicated—

that is sufficient relative to other competing activities and to the comparative amount of activity that we want to generate so that we engage enough businesses in creating affordable housing that all the public resources we have to put out there can be utilized on developments of reasonably high quality with sound management.

Obviously, that kind of standard is a fairly relative standard. Let me say I've been in this business for 20 years. I don't know anywhere near enough to pick a number, to pick a range, to pick even a way of calculating what the magical, just right profit and incentive level is.

Let me give an example from our recent experience in Massachusetts. We have a state rental assistance program, and there have recently been discussions about doing another competitive round for funding allocations under that program, in which I have participated as chairman of the Multi-Family Advisory Committee of the Massachusetts Housing Finance Agency. Those discussions have included the question of what 10-percent allowance for development overhead and profit would be sufficient to generate enough good proposals in the current environment. What is the current environment? First, it is an environment in which there are limited state resources because of State budgetary problems and, therefore, only a limited number of projects are going to be funded. Second, our real estate economy is not in the greatest of shape. So the competing opportunities for developers to be sought for doing that limited number of projects are quite limited.

Number three, we have an active, healthy nonprofit sector doing half or more of the affordable housing production.

In the context of all three of those circumstances, it's my view and the view of a good number of people involved in trying to assess this question in Massachusetts, that a 10 percent profit level for developers for the next round of that program would be an appropriate level that would provide enough incentive and get enough competition to give the State high-quality projects to be able to fund.

Take another environment. What if we were trying to produce a significant number of projects, not just a few?

What if the real estate market was hot and not cold? So there were competing activities that developers could engage in?

What if there were no nonprofit sector, so, basically, there needed to be enough incentives to motivate for profit developers to do all those projects?

What's the right number? Fifteen percent? Twenty percent?

I think the point is that the number clearly depends upon the context, the context of the environment in which development activity is seeking to be generated, the environment of the kind of projects and the kind of risks in those projects that are being undertaken.

Let me mention some principles that I would propose for your consideration in this area.

First, I think standards for incentives and profit need to be set very close in time and place to the actors that we're trying to regulate and trying to provide incentives to.

The Tax Credit legislation that provides for States to make those kinds of determinations has those determinations being made close enough to the local markets.

H.R. 1, the requirement that HUD set those standards nationwide, unless there's some way of delegating or breaking that down more locally, has HUD already croaking under that requirement. And it probably, frankly, doesn't work.

Second, I think it's important to maximize the competitive process as a way of telling what kind of profit and incentive margin is enough. With all due respect, if I, after 20 years in this business, shy away from the question of what is a reasonable incentive level to stimulate production, how can a congressional committee or HUD come up with a magic answer that's going to fit for the whole country?

Let the competitive market place instead of some sort of governmental judgment regulate what kind of profit levels are needed.

At the same time, we need to be careful about that competitive process. This is again an area where HUD has had problems in the recent past. In the property disposition program of HUD, they've often used the competitive process to try to minimize the cost to the Government—in deciding who's going to buy this property that we're disposing of and keep it at low income. If they can operate it, if they can get it rehabbed, as much as they'll pay for the property and as low as they'll take the section 8 rental levels, that's what we want, says the Federal Government.

What do they get when they do that?

They get developers who underestimate the operating costs, underestimate the rehabilitation costs, acquire the properties by outbidding other developers, do a hell of a job and it's back in HUD's hands in 5 years.

So we need a competitive process, but we also need a managed competitive process that doesn't allow those kind of abuses to take place.

Third, we need an incentive structure where we correct some of the kind of abuses we've had in the past.

In the past, if you were getting your housing funding through direct assistance, if you were to pump up that budget, basically, the higher your costs were on your production side, the higher your basis for tax credits and for depreciation deductions were on the investment side. And the more money you raised on the investment side.

Well, if you got all your costs on the production side covered by the direct assistance programs, loans and insured loans, and all the investment incentives are your profit, the higher those costs are, the higher your profits are.

An incentive system like that doesn't work. We need an incentive system that does.

The fourth point that I would make is that we have to remember, we have to be careful not to throw the baby out with the bath water. We have to remember that the most important judgment for allocators of public resources is not is this developer making the least possible profit, but are we getting the most public benefit for the dollars that we're spending?

And it may be in a given situation where developer A, who bought his land cheaper than developer B or has some other economies that the other developer doesn't have may have two or three times as great a profit margin as the other developer and yet be able to deliver, in terms of public benefit, more affordable housing at less cost to the Government.

That ultimately has got to be the most important criterion.

To conclude, I think that the effort that you've begun here is critically important and long overdue. It's also important not to try to cut the line too fine. It's important to work quickly to help HUD out of the paralysis that Sheldon Baskin referred to, which has set in upon it, where right now they're afraid that if they make a decision to have some housing go forward, they're going to be scrutinized and questioned by committees like this, about whether a developer made an extra dollar, so it's easier, safer and their incentive right now is to do nothing in that situation than to do something and run the risk.

We've got to turn that incentive around and get HUD back in the business of helping to create affordable housing.

I think, at the same time, we have an opportunity currently to design an overall way of looking at incentives to bring more efficiency to the use of public dollars and, by doing so, to increase the public support for a larger and growing Federal, State and local role in public support and assistance for affordable housing production.

So the promise of 50 years ago that Marilyn referred to can at along last be met.

Thank you very much.

[The complete prepared statement of Patrick E. Clancy follows:]

TESTIMONY OF

PATRICK E. CLANCY

EXECUTIVE DIRECTOR

THE COMMUNITY BUILDERS

BEFORE THE

HUD/MOD REHABILITATION INVESTIGATION SUBCOMMITTEE

COMMITTEE ON BANKING, HOUSING, & URBAN AFFAIRS

UNITED STATES SENATE

"ROLE OF THE PRIVATE SECTOR: AN APPROPRIATE LEVEL OF PUBLIC INCENTIVES FOR PRODUCTION OF LOW & MODERATE INCOME HOUSING"

FEBRUARY 27, 1990

Mr. Chairman and Members of the Committee:

My name is Patrick E. Clancy, and I am submitting this statement to you as executive director of The Community Builders. The Community Builders is a nonprofit corporation providing a full range of real estate services - development, financing, and management - to local communities in Massachusetts, Rhode Island, and various other locations throughout the Northeast for the production and operation of housing for households of limited means.

For the 25 years of our existence, we have assisted in the creation of approximately 5,000 units of affordable housing with total financing of approximately $275,000,000; we have an additional $100,000,000 of housing under construction, and another 2,000 units under development.

I would like to comment upon the role of the private sector and the question of the appropriate level of incentive for its participation by looking at four elements. First, an historic overview of private affordable housing production and incentives will establish a context for the current discussions. Second, a review of the makeup of the private sector affordable housing industry as it exists today is important to your deliberations. Third, I would like to put forth my thoughts on the question of the appropriate level and measurement of incentives. And fourth, I would like to conclude by suggesting some critical priorities as we look at the issue of incentives and future affordable housing production.

I - HISTORIC OVERVIEW

Since the Tax Reform Act of 1969, the federal government has generally played a dual role in supporting the production of decent affordable housing for lower income Americans: it has provided direct assistance through capital and operating subsidies through the Department of Housing and Urban Development; and it has provided investment incentives through federal income tax benefits provided in the Internal Revenue Code. It has consistently been the case in my experience over these last 20 years that generally both direct assistance and investment incentives are necessary to create affordable housing and neither are in and of themselves provided at a level to be totally independently sufficient. Congressional staff have not always realized this: when Section 167(K) of the Code was first passed to provide 5-year amortization of rehabilitation expenditures for low income housing, it was assumed by Congressional economists that it would stimulate rehabilitation for low income people independent of the direct assistance programs of HUD. It never did. Similarly, when the Low Income Housing Tax Credit was passed in 1986, it was assumed by staff of the Joint Committee on Taxation that it would stimulate low income housing production separate from other state, local or federal assistance. It has not.

Yet in the face of a consistent 20-year experience of affordable housing being produced only where direct public assistance and investment incentives through the tax code are both utilized, the worlds in which each form of public support exists have been totally separate worlds and the public actors in each of them have never taken into account the public role and actors in the other. More specifically, HUD has never understood, nor tried to understand, in its various insurance and subsidy programs - with the sole exception of the UDAG program, which is not a useful model for reasons I can elaborate upon if desired - the value, relevance or importance of investment incentives available to the projects it financed through the tax code. It is not just HUD that has functioned in this fashion. Every state housing finance agency in the country has provided debt financing subsidized through the issuance of tax exempt bonds, in many cases combined with operating or capital assistance, without considering, measuring and weighing the combined value of these resources and of the equity capital available through utilization of investment incentives provided through the tax code. This may sound hard to believe given the recent investigations and the clear inter-relationship of direct assistance and investment incentives, but let me stress that it has been the status quo for 20 years.

An example of the separate worlds of HUD assistance and equity financing is in order. For the first several years of my experience in this business, it was common for nonprofit organizations to utilize 100% mortgage financing which, including overhead allowances, covered 103% of the direct project costs of housing developments. This was in contrast with for-profit developers utilization of HUD financing that provided approximately 97% of project financing, assuming the developer was not writing up land acquisition costs. It was a common perception throughout HUD that nonprofits were getting a higher portion of financing than for-profit developers. This perception totally ignored the fact that for-profit developers were getting another 15% out of the value of investment incentives available through the tax code which nonprofit developers were not able to use. Needless to say, nonprofit developers soon figured out how to alter the situation and to utilize the investment incentives themselves, but the point remains: the perception of HUD of what it was doing was limited to its knowledge and understanding of the direct assistance and financing programs it operated, and it existed in total darkness with regard to the additional value provided by investment incentives through the tax code.

This complete independence of the world of direct assistance and investment incentives quite logically led to highly inconsistent levels of efficiency in the combined outcomes. For example, the rapid amortization for rehabilitation expenditures to which I referred earlier worked reasonably well - albeit differently than Congress had anticipated - in combination with the Section 236 interest reduction program, a moderate level of HUD direct assistance, to produce significant inner city rehabilitation in the early 1970's. However, when the Historic Rehabilitation Tax Credit was passed, and this credit could be combined with the rapid amortization of rehabilitation expenditures, and the 236 program was replaced with the deeper subsidy provided under the Section 8 Program, that combination of deeper direct assistance and more substantial investment incentives made for a package of benefits that were significantly richer than they needed to be.

With the Tax Reform Act of 1986, the Congress for the first time took a much closer look at the issue of combining direct and investment incentives. In my opinion, the concern expressed during the legislative process in which the low income housing tax credit was created with "double-dipping" - the combining of investment incentives with direct assistance - was a concern uninformed by 17 years of history. It was clear to virtually all of us in the industry that the low income housing tax credit would only produce affordable housing where it could be used in combination with direct assistance. Thus, the issue more appropriately was not whether direct assistance and investment incentives were being combined, but whether the aggregate combined level of both resources in the context of the cost of the project being undertaken, the level of affordability being provided, and the level of return necessary for developers and investors in the marketplace were in the aggregate reasonable or unreasonable. With the recent HUD scandals, the 1989 changes to the low income housing tax credit provision, and the provisions of the recent housing bill, we are finally at a point where HUD and state governments need to look at the full picture and at the total envelope of assistance resources, direct and through the tax code, to assess an appropriate level of overall incentives and assistance. This is where we should have been 20 years ago. And it is the kind of coordinated consideration which I urged in the paper I prepared that was discussed with this committee almost two years ago (Tax Incentives and Federal Housing Programs: Proposed Principles for the 1990's). At the same time, it is a critical starting point for your considerations to realize that we have not been there at any time in the last 20 years and that figuring out how to get there responsibly and expeditiously to keep affordable housing production moving forward is indeed a challenge.

II - PRIVATE SECTOR AFFORDABLE HOUSING EFFORTS

We have witnessed over the past 20 years an evolution of the for-profit development community creating affordable housing. In the early days of this period, developers with substantial activity in conventional rental housing development and commercial real estate were major participants in the production of affordable housing. As the programs have gotten more complex, the average size of projects funded dropped significantly. As the ins-and-outs of the political funding game became more baroque, we have seen the evolution of a narrower band of for-profit developers expert in affordable housing programs increasingly focused on those programs and that kind of development. As federal dollars have disappeared and in many areas have not been replaced with state or local funds, these developers have once again diversified back into more commercial activities.

At the same time, the past 20 years have seen a continually expanding evolution of nonprofit development organizations and a continually increasing average size to the projects they undertake and to the "market share" they represent among the total production of affordable housing.

I want to be clear that I believe the trend for nonprofits to be undertaking an increasingly larger share of affordable housing production in this country makes sense and should be encouraged as a matter of federal housing policy. Nonprofits have the potential to offer the best of both worlds:

- the entrepreneurial, business-like approach to housing creation and operation that is unencumbered by the political and bureaucratic entanglings of public entities and

- the social purpose to make the million and one decisions required by applying a calculus that seeks to stretch resources to maximize social return and not the calculus of minimizing risk and complications and maximizing financial return.

Increased federal support for the expansion of the nonprofit sector through such legislation as the proposed Community Housing Partnership Act can further this trend and bring ever closer the day when we have a large scale national industry that is utilizing public resources with a public purpose in the production of affordable housing on a scale commensurate with the need.

At the same time, I believe quite strongly that for the indeterminate future the continuing substantial role of the for-profit development sector is critical to affordable housing production. The for-profit sector is critical to affordable housing production achieving any significant scale nationwide, given the quite modest volume of production and scale of capacity of nonprofit organizations that remains in many parts of the country. In addition, the continuing engagement of the for-profit development community is essential to ensure that we draw on the talent of one of the most entrepreneurial sectors remaining in the American economy to meet one of the most crucial of our social needs.

III - PUBLIC INCENTIVES FOR PRIVATE PRODUCTION

The main question posed to this panel today in regard to the provision of direct and tax investment incentives is simply stated: "How much is enough?" The simple answer to that question is that there is no simple answer.

First, let's parse the question. Who's incentive are we talking about? The incentive provided to developers to undertake the development and long term operation of affordable housing? Or the incentive to investors to invest in affordable housing projects and receive tax benefits over a 10, 15, or 20-year investment period? I will focus of my remarks on appropriate incentives for developers, since this is the more complex and critical question and since investor returns can more easily be left to the workings of the marketplace.

Let me try to formulate a very general answer to the question of "how much is enough". Incentives for affordable housing production must be designed so that they provide:

(a) coverage for anticipated and real overhead, staff time, time value of money spent on up front costs, and a wide variety of other direct out-of-pocket expenditures;

(b) a reasonable margin of safety for developers, funders, and lenders; and

(c) an ultimate return potential that is sufficient - relative to other competing activities

> and to the comparative amount of activity that is hoped to be generated - to engage enough businesses in affordable housing that all of the public resources available can be utilized on developments of reasonably high quality with sound management.

A number of observations are in order about this general standard. First, I confess that I am certain that with my 20 years in the affordable housing business I don't know enough to propose a magic number or even a range of numbers that represent the right percentage level of return to provide a "just right" incentive level for affordable housing production efforts.

Second, there is obviously a different margin required and a different "hurdle rate" for for-profit as opposed to nonprofit development companies. However, even for nonprofit development companies, a level of incentive that enables all costs to be covered, provides a reasonable level of reserve and that supports their continuing operations, is essential to participation. For example, changes over the last several years limiting staff costs and the ability of one organization to provide an array of services in the HUD Section 202 elderly housing program has resulted in organizations, such as my own and others, not utilizing the program other than in special and isolated circumstances and, as a result, states like Massachusetts turned back dollars where they used to have excessive demand on dollars available under that nonprofit program.

Let me describe some recent discussions that I have been a part of and what they tell me at least about the context for those judgments. In my position as Chairman of the Multi-Family Advisory Committee of the Massachusetts Housing Finance Agency, I have been actively involved in discussions of changes to the guidelines of a major state assistance program for affordable family mixed-income housing production. In designing guidelines for a potential next round of funding, the issue of an adequate but not excessive level of return for developers has been discussed. This discussion has taken place in the context of:

- limited state resources with significant state budgetary problems, and therefore, the prospect that only a quite limited number of projects will in fact be funded;
- limited other opportunities for developers given the dismal state of the Massachusetts real estate market; and
- substantial (50% or more in recent years) contribution and production capacity for affordable housing in the nonprofit sector with its commensurately lower hurdle rate for incentives.

In the context of all of these elements, the notion that a number of people including myself would feel confident about is that a 10% margin above costs for profit will prove adequate. What does that mean? It means that 10% of the total development cost is available to cover a staff cost of developers, their overhead, the time value of their up front investment, the margin for risk and for contingency and for net return to compensate them for their work. But what would be an adequate return if instead the environment were one where:

- substantial incentive dollars were available and significant production was being sought;
- a strong real estate market offering significant other opportunities for developers; and
- the nonprofit sector in the area was very, very small.

Would the magic number then be 15%? .. 20%? Clearly the question does not lead to an easy numerical answer.

A major additional complicating factor is that, of course, different types of projects have different levels of risk. How does one weigh the differential risks of inner city, scattered site low income family housing versus suburban elderly single building developments, let alone the million gradations in between, in a fashion that prioritizes the needs seeking to be addressed?

I want to be clear that my objective here is not to clutter your considerations with too many elements but to make agnostics of you all about your ability to establish national unchanging objective criteria for the appropriate level of incentive and return for affordable housing production.

So what can you do? Let me suggest several principles for this quite important and long overdue effort that you are considering.

First, it is important to set standards for incentive and return most proximate in time and place to the actors whose productive engagement is being sought. This means setting the standards as close to local markets as possible. The provisions in the 1989 tax legislation that call for state tax credit allocating agencies to determine the appropriateness of tax credit incentive levels fixes this responsibility at a reasonable level - state government - close enough to local markets. Similarly, the standards need to be set and continually adjusted as, over time, these various markets and the relative environment for affordable housing production shifts.

Secondly, it is important to seek to the maximum extent possible to establish competitive processes for determining what the traffic requires and will bear in terms of incentive and return levels in place of relying on governmental bodies' judgments of what is necessary and appropriate. Again, the various complicating elements of how those judgments get made and how they can accurately be made, as I have described above, should induce public actors to seek to answer the question to the maximum extent possible through the workings of the competitive process.

Thirdly, standards that are established and the way in which they are established need to be designed to provide an incentive structure to assure that they lead to the maximum utilization of public resources for the desired objective and that they lead to maximum cost efficiency. This has often not been the case. For example, where syndication proceeds from sale of investment benefits provided virtually entirely the profit margin on developments, the incentive was to have total development costs as high as subsidy levels could be generated to support them, so that depreciation, credits, and other investment benefits based upon total costs were as high as possible and profits were maximized. This has been one pattern of an incentive system working backwards which is the kind of thing that needs, obviously, to be avoided.

Fourth, it is important to keep in mind that the bottom line for appropriate public judgement is the overall efficiency of the use of incentives more than the comparison of the return to developers in one project versus another. For example, a project where a developer is making a 15% return but bought the land cheaper and is building cheaper and is providing a significantly greater level of affordability may be a more efficient place to allocate scarce resources than a development where the rate of return is only 5% but higher cost levels result in less public benefit per public dollar. In turning reasonable attention to regulating the level of return and avoiding the excesses of the past, let's not take our eye off the ball!

IV - CONCLUSION

Although it seems unbelievable, these discussions today are a part of an effort which for the first time in 20 years seeks to look at all four corners of the incentives and resources provided for affordable housing and to weigh the appropriateness of those resources against the public benefits and the private returns being provided. This is fantastic, 20 years overdue and also quite scary.

There is an urgent need to make this kind of analysis as demonstrated by the scandal you have been considering in the Section 8 Moderate Rehabilitation Program and the complexities of the judgments involved. I must tell you that HUD's ability to act on projects submitted to it for its approval has come to a virtual standstill. We have now replaced a Department of Housing and Urban Development that was giving undue weight to political considerations, with a HUD overly concerned that an extra dollar of benefit might seem to a congressional committee to be excessive. It is easier - and probably much more acceptable to the Office of Management and Budget - not to act than to try to work through the thicket of considerations that I have tried briefly to describe and to come to some basis for action.

We run a very great risk, therefore, that if we try to cut these matters too fine, we will leave ourselves with an outcome of continuation of far too little affordable housing production and delude ourselves into thinking that a great record of not providing anybody an extra dollar of incentive is what our public purpose in affordable housing should be all about.

At the same time, we stand at the beginning of a period of unique potential in affordable housing production. We have the chance to design incentive structures that stimulate a more efficient utilization of direct assistance and of investment incentives. If we are successful, the improved efficiency of our use of public resources can enhance and expand the public support for continuing engagement of the federal government and of state and local governments in provision of decent housing for all our citizens. Further, we have an opportunity in the structuring of those standards and incentives to design our approach in a way that will continue to encourage and support the expansion of the contribution of the nonprofit sector toward meeting our affordable housing needs, and thus continually reducing the disparity between public interest and private benefit that is of so much concern to this committee today. I applaud your efforts and will be pleased to do whatever I can to assist them.

Senator **Graham**. Thank you very much.

Each of you has made a very thoughtful and helpful presentation. We are very appreciative. I recognize that you have at some considerable effort come to be with us today.

Senator Mack and I thank you for that.

At our morning hearing, Mr. Baron had a proposal for a greater use of block grants.

Did you hear Mr. Baron this morning?

Essentially, his idea was that more discretion should be given at the local level. And I think he would define that as being primarily in a public housing authority level to utilize funds across a range of potentials, whether they be section 8 certificates or funding for modern rehabilitation as the specific requirements of that community dictated against a consistent standard of how do we maximize the availability of housing to low-income Americans?

I'd be interested in your thoughts as to the relative placement of responsibility for decisionmaking and whether the pool should be a large one or continue to be as it is today, a series of small puddles, each one largely independent of each other?

Mr. **Baskin**. If the Government would adequately fund the block grant program, such as Mr. Baron described, that would be great. It would be a huge improvement and I have no quarrel with that at all.

I do think I have a little bit of a different view than most people about local versus Washington and all that.

I think that HUD, the way it ought to work, is really very local. I would say probably the people in the Department of Housing in the city of Chicago right now are less "local" than the local HUD field office people have traditionally been.

So, most of the decisions that, in the past, were made by HUD weren't really decisions made off in Washington; they were made locally by people who lived their whole lives in Chicago and who knew the local market.

And I don't have any objection to that.

I think what's happened recently is every decision, at least every one we're involved in, seems to have to go to Washington. There you have a small number of people, some of whom are very competent—some of the few competent people left at HUD are in Washington—but they can't possibly make every local decision throughout the country. If HUD was working through its local offices the way it should, then I don't have any problem with programs being administered to a much greater degree by HUD, and you don't have to go the full block grant route because the Federal Government isn't going to totally give up control over those funds anyway.

You're still going to have some guidelines. You're still going to want to make sure the funds are used for poor people and these other kinds of reasons that you appropriate the money. And you're still going to have somebody to look after that and make sure the cities are doing it right.

So you're still going to need HUD. And the important thing is that whoever administers it is competent.

In past years, HUD and our State agencies have probably been more competent than our city agency. That's in Chicago. It's not true in St. Louis, where they've had very good city agencies involved in urban renewal and housing. And that's the experience Mr. Baron had.

Ms. KOLLIAS. I'd like to comment on that as well.

I think that it is important to be able to have the authority to implement the policy on the local level.

One of the things that's been missing and I've had an opportunity to be at the Federal level working at HUD, as well as working in a nonprofit community organization now in the private sector, being able to see how the pieces are put together.

What we're missing on the national side is a policy that really embraces how partnership efforts should be defined and implemented on the local level. So that you have on the local level the ability to be responsive to the issues that are unique for each locality.

You can target investments on a neighborhood by neighborhood basis. You can look at those things that are critical on a real microscopic level rather than trying to dictate a national product.

But, nationally, it needs to embrace those elements, so you don't have local abuse, confusion or you're subject to those things.

The block grant, again, if adequately funded, as well as even the HODAG or UDAG, which I know are things that were cut away—and I see that UDAG was one of the examples in St. Louis—those are but four projects. Those allowed the money to be in but for that particular source, and how it is actually structured in that project.

That project would not go forward. That allows the maximum creativity of all the players involved, and I think that that is the type of situation that we need on a private sector basis when we land and there is public sources involved, whether it's block grants, HODAG or rental rehab.

The public sources are being leveraged in a way they haven't been leveraged before. They could see 6 or 7 of our dollars to every dollar they put in; whereas, before, they might have been the sole lender in many of the cases.

Ms. MELKONIAN. I just want to comment very briefly because my company represents the city of St. Louis right now in looking at its inventory of HUD-assisted projects, looking at its public housing, looking at the various housing opportunities in the existing housing market.

And the point that you are raising is exactly something that we'd like very much to be considered for the following reason:

Some public housing built, for example, 25, 30, 40 years ago in the city is obsolete. Yet, under the current modernization program, there could be vast amounts of money for the city going in to modernize those buildings.

That's not something that would necessarily be done if there were flexibility to treat the funding in a fungible way. And, yet, that doesn't mean that you would not have affordable housing units serving exactly the same people.

You would just do it differently, in a way that's more compatible with the city's growth and development right now.

So I think that is something that needs to be thought about and obviously the block grant tool is a most flexible tool for funding at the local level. And, in fact, I think we're going to be bringing forward a proposal for the city of St. Louis to try out those ideas and create a model that we could legislate, even on an experimental basis.

But I also want to say that HUD is an extremely important institution in this process and we need to have national leadership on the housing issue and HUD is the institution that we should reinforce, build up, and strengthen in order to play that role. It has really been stripped of that capacity over the last 10 years.

And that means investing in it as an institution to make that leadership possible.

Senator **Graham**. Senator Mack.

Senator **Mack**. First of all, let me also express my appreciation for all of your comments today. As I listened to all four of you, I've been trying to figure out where to start in all of this.

One of the things that did come to my mind though was you mentioned leveraging. When I was in Tampa, FL looking at what they're doing, one of the points that they kept making to me was given (a) the limited resources, the thing we ought to be trying to do is find out which communities around the country, in fact, are committed to public housing, affordable housing, to providing affordable housing and the concept of leveraging is one that keeps coming back to me.

I would be interested in your thoughts as to what we can be doing that would bring about greater degrees of leverage.

What are the things we need to do that are going to encourage the flow of capital into the various housing needs?

And that's directed to all of you.

Patrick, you can go ahead.

Mr. **Clancy**. Yes. Let me start by saying I think leveraging is an important principle that has really been behind a lot of what we've done over the last 15 years in affordable housing.

At the same time, a cautionary note. The ability to sell HUD that their dollars are being leveraged combined with the ability to sell state government that their dollars are being leveraged and to sell local government that their dollars are being leveraged and a tax credit investor that their dollars are being leveraged, and a foundation that their dollars are being leveraged creates an enormously complex management task for actually putting together the total pool of financing.

It's the puddles that you referred to earlier, Senator Graham. Combining enough puddles to make a pool that you can actually take a swim in.

And I think leveraging is important. I think one of the challenges is to look for ways that Federal dollars can be leveraged by other dollars and can contribute more and can provide incentives to States and localities to put up dollars.

I would just add to the other comments made on an earlier question that, in that regard, we should not forget the State housing finance agencies to the extent that there is a successor group of public housing and financial professionals who have sort of filled the gap that has been created by HUD's withering away. That gap has been filled to a larger extent by the State housing finance agencies and their financing and subsidy roles over the last half dozen years. Leveraging resources by providing them in matching ways to State level housing finance agencies that are working effectively with localities in their States, I think has a lot to be said for it.

Ms. KOLLIAS. One of the things that I was going to mention to be a little bit more specific in terms of how leveraging might be able to work.

First of all, that is assuming that you have the ability through HUD and the community development block grant type of resource that you can do certain things. And some things will need increased funding as well as some may be legislative changes.

For example, from the private sector, if you're trying to get more private sources, then you need to work in concert with also the secondary mortgage market, so that we also know that there's long-term institutional investors that are out there so that we can match up the type of funding that we're doing on the short-term with the long-term.

We can lend more if there are sources that can act as credit enhancement, especially on a debt service coverage ratio. If you have to look at, as I mentioned in my presentation, that you have to have a certain amount of cash flow for every dollar of debt, the secondary market likes to look at anywhere between $1.10 to $1.20 or so.

If you could do better, like almost do a break-even if there's some type of credit enhancement—and that could be available through some type of organized mechanism in the form of guarantees with community development block grant moneys, but that varies from locality to locality in terms of how they want to utilize their resources and how that's interpreted legally.

In addition, you could do forward funding. Instead of take-downs at the front end, you could put the money into the institutions and you can draw off the earnings. And that could help write down some of the other traditional sources of financing.

That would help. Being able to even give the direction where if you can prioritize the leveraging, then that would give the localities a better incentive to go out and work with lending institutions, or collaborative private interests like the ones we have here to sit down and cut a deal; because they know that they, in turn, could go back to HUD and probably get better attention because they know that they're going to be able to utilize their resources more.

A lot of it is going to have to be able to understand that we're trying to look at being smarter on the financial structuring and backing into how to fill those gaps. And the gaps do vary from project type to different locality situations.

And we have to look almost at a discretionary block grant in the form of like a line of credit that would go back and forth between HUD and the localities. And there would be to be some technical backup and specific direction to make sure that those localities that have not been as active in the past will be able to utilize this more flexible ability to leverage.

Mr. BASKIN. Let me pick up on a different part of this, the negative side, which Pat began to get into, I think.

This has become almost institutionalized. If I go to a source of funding and I say I need $1 million to do this project, and I can do 20 units, they are likely to say to me:

"We can give you a couple of hundred thousand dollars and why don't you go to all these other places that I've referred to and get a couple of hundred thousand from each of them? Then you'll have your million and you can do your 20 units?"

This makes it extremely difficult for me to do a project. Everybody wants to know everybody else is committed before they're committed. You've got to get five balls in the air at once. And how many different sources there are. And each source then has to examine the project.

There's time delays. We have to negotiate legal documentation with every one of them. But the reason I say it's institutionalized is because each of these sources then writes its annual report and says:

We did five projects and we leveraged a hundred units.

Now you have five sources each saying they did a hundred units and it looks like 500 units were done. Really, there were only five 20-unit projects. There was only 100 units, but everybody looks good. So everybody wants to leverage their resources and nobody wants to finance a whole project.

Now, as I think you gentlemen rather astutely noticed this morning, most of these subsidies in the Brewery project in St. Louis, most of these sources came back one way or another to the Federal Government. Either they were tax benefits. They were CDBG's, there were UDAG's, tax-exempt bonds, mortgage insurance.

Really, at some level, the Federal Government was behind most if not all of it. As long as that's the case, if you really want to do some housing and funding levels aren't at a level to do much, but if you really wanted to do some housing, we ought to go back.

When I started in this business, we had 221(d)(3). You went to FHA. You got an insured loan at a low interest rate, which actually, when the program started, cost the Government nothing because Treasury bills were 3 percent then and it was one-stop shopping and you could serve moderate income tenants with only that FHA mortgage.

Now what you would have to do is also bite the bullet on what these things cost. Those costs that seem so astronomical in the St. Louis project, that's what it costs to do housing in cities today, even ones less complicated than that brewery.

And that would be a lot more efficient way to do the housing and you'd probably get more out of it for your Federal dollars than all this so-called leveraging that goes on.

Senator Mack. Let me just—I appreciate that comment. I guess the perspective I was coming at was that it appeared to me that the concept of leverage was almost from the perspective of let's say HUD, in trying to determine where it's going to allocate its resources, if you had a community that had banks, for example, that were active in lending and they were active in lending from the standpoint of low interest loans, whether that was for home ownership, whether that was for redevelopment, HUD's concept would be:

Well, that's a community where we ought to put our funds because we're going to get assistance as opposed to communities that were having difficulty in getting banks to participate in low-income lending.

And that's part of the concept I was looking at when I was talking about leveraging. It's just to get communities more active in assisting the development of housing.

Is that different?

Mr. **Baskin**. That's helpful but I think the banks, there's a group of banks called Community Investment Corporation in Chicago, makes loans on inner-city projects. But they do the kind of underwriting that Karen was talking about. They work for coverage. They get a market rate of interest and they have regulations. They have shareholders. I think it's useful that they participate in the process.

But, they're not really subsidizing anything and there has to be a subsidy to serve low and moderate income people. And, really, ultimately, that's going to come from the Federal Government or it's not going to be done.

Senator **Mack**. Marilyn.

Ms. **Melkonian**. HUD has no funds, OK? HUD had—the only funding that HUD has right now is to maintain existing commitments to the 4.4 million units of housing under the voucher certificate, (d)(3), 236 section 8 and public housing programs, period.

The CDBG funds are formularized; sent out to communities based on all the factors that you know. HUD has no investment funds. We are truly at the bottom.

So that's where we are and that's why these kinds of discussions are very important because we are talking about how we are going to rebuild. What is the new ethic? What are the new standards? What are the new ways of doing business? And how are we going to take advantage of everything we've learned when we build up again?

But, HUD has no ability to do what you're talking about today.

Senator **Graham**. Going back to that St. Louis project, which I'd like to visit sometime, it looks as if it's very creative.

The concerns that I have include $65,000 per unit looking at the distribution of the section 8 units, which were an average of approximately 650 square feet. That means that we were paying roughly $100 a square foot to build those section 8 units.

I don't know what it's like in the cities that you represent, but I know you can build for a lot less than $100 a square foot in places with which I'm familiar.

Clearly, we had there something other than the goal of providing affordable housing. We were also attempting to stimulate a neighborhood engaged in some worthwhile and important public policy.

I'm concerned that we seem to have some confusion. We have an orchestra without a conductor in terms of multiple objectives with each player playing the music off his own sheet and then trying to push that orchestra through a single set of housing programs.

I'm not going to pursue that analogy. [Laughter.]

I think it ran out several sentences ago. But I would be interested in your thoughts as to whether it is possible to disaggregate what it is we're trying to accomplish and more clearly assign a cause and effect relationship.

We are trying to accomplish the purpose of revitalizing a neighborhood. Here is how we are going to do that, but not attempt to revitalize a neighborhood through plain, excessive costs. And that's my characterization for a housing program.

Mr. CLANCY. You know, we've had a lot of discussions, particularly over the last year or so in Massachusetts about cost of production. And, again, I think these issues relate a lot to context. We have come out of an environment where our real estate economy and our building economy in the city of Boston, for example, was extremely high.

Well, if you need a contractor who can build 75 units of housing to build your housing development in a neighborhood of the city of Boston and you're competing with commercial development work where there's more work than there are builders, you've got a heated marketplace and your costs in that marketplace are going to be greater than they are when that marketplace cools off.

Again, you have the question of local markets. There are many places where, in the short term, building new housing is more expensive than acquiring or rent subsidizing somebody to go into an existing unit. Long-term, I think, and Marilyn made this point earlier, I think that we create a more permanent stock by building and, in fact, we are amortizing that up front cost over a much more extended period of affordability as opposed to putting somebody in a unit where the cost of that unit, because it's conventionally owned and unrestricted, goes up as the market goes up.

So, when we look at housing that we developed 20 years ago and the rent levels needed to keep it affordable there are far less than the rent levels of the section 8 certificate program in private, unrestricted, commercially owned housing that are required today.

I think it's important not to overpay for housing creation and for affordable housing. At the same time, I think, if we look at long term, if we look at leveraging our resources, production has significant cost efficiencies over the long term.

Ms. KOLLIAS. I was going to mention that sounds like what you're trying to get at is what I was also saying is a good reason for partnerships between lenders, as well as public officials.

That is trying to balance the economic viability of transactions but within the context of having substantial community benefit, specifically in the form of neighborhood revitalization.

I would hope that a lender would look at total development costs of a certain per unit and say what's wrong with this picture. You know, they will only lend to a certain extent of that number.

But, hopefully, beyond that, they would also look at what are those things that are so unique that it might be a certain dollar per unit, which is in excess of what they might typically see.

I had mentioned before that the one thing that changes as a variable, which I think Pat also mentioned, is from neighborhood to neighborhood you can have an acquisition price which can get a little bit out of hand depending on where the gap in the subsidy has to come in.

But, if you're dealing with new construction adapted for use or gut rehab, you'll have varying costs within there.

But you'll have some kind of measure of what makes sense. So, if you have a private sector lender in there, and that might help in terms of measuring the economic viability—and while I understand the concerns about not wanting to have to go to a lot of different places to pool your resources together because it's also very complicated for private lenders to have to figure out all the various different acronyms of the Federal programs, that it will make sure that you can keep some of your transaction costs down.

While you might get a below interest loan from a HUD program, the transaction costs and the time and the delays from that might offset what in fact could be a blended rate of one subsidy with one market rate loan.

So I think it is important to look at them in the neighborhood context.

What is the cost to revitalize the neighborhood? How that gets expensed over several projects.

You do have to have some economic indicators on a project by project basis. Otherwise, it might end up back in your hands or another lender's hands and none of us wants that.

Senator **Graham**. I guess I'm also asking this from an intergovernmental perspective. The national responsibility as defined in the 1949 Housing Act was to provide affordable housing for American families. It seems to me that is a very important national goal.

I have some questions. Then we will get into the issue of community revitalization. If you've only got a certain amount of resources to spend, I would make the case that the National Government ought to concentrate on spending its resources to meet the goal of affordable housing.

But, if a community, a city or a State wants to complement, supplement or enhance that with resources so that its goal of achieving affordable housing will also achieve some other objectives, i.e., community revitalization, that should be encouraged.

But, that should be a responsibility at the State and local level.

Mr. **Baskin**. I think it's a question of whether you can isolate the housing because if you put the housing in the context that can't support it in 5 years, you're not going to have the housing any more. That was the concept of the model cities program.

And the basic concept of that was right. You have to do more than just supply the housing. And that I think is what Richard Baron was saying.

Also, when he tries to do economically integrated projects, they have a better chance of success than all low income—although I don't know how he does it. It's very difficult.

Senator **Graham**. I agree with him. In a world in which we were unrestrained with resources, you've made a compelling argument. But, the fact is every thousand dollars that you spend in that $65,000 project means that a family is living out on the streets.

That's the trade-off that, with a fixed amount of money that can be available, the person who carries the onus of less than maximum efficiency in the use of that money against the purpose of providing affordable housing are those who go unhoused or ill-housed.

And I come back to the principle and I may be arguing the devil's advocate to have a discussion on this topic, that if the Federal Government returned to its core role of assuring affordable housing and then, in a collaborative partnership with communities, States, and the private sector, could serve as the catalyst to achieve other purposes which other sources of funds would finance, we'd all be happy.

Mr. Baskin. As long as you do them together. I meant to play the devil's other advocate, but if you take too narrow a focus just on the housing, then you have another, I go and eventually blow it up and you didn't really solve the problem for those other homeless people.

Mr. Clancy. But, in an environment where we are talking about creating incentives for other actors, for the major cities across this country, for the State agencies trying to deal with housing, if the Federal Government came back to provide significant resources focused on what affordable housing needs and left the ancillary costs for more expansive efforts to States and localities, we would be a heck of a lot further ahead than we have been. That kind of division of labor, I think, certainly has potential.

It's not necessarily cost savings because, as Karen was suggesting, and it's certainly been our experience in Boston, we can do stick-built, spread out townhouse construction in suburban areas and build at $25,000 a unit cheaper than we can build four or five story developments, a whole other fire code grade in an inner-city neighborhood, where land availability and the fabric of the neighborhood requires a denser kind of development.

Also, it's a question of where people are. I remember when HUD had something called site and neighborhood standards back about 10 years ago and they were well-designed, what they tended to do was make sure that we weren't putting all that low-income housing in inner-city impacted areas but were providing opportunities outside of those areas.

However, in the implementation of those, we ended up working with inner-city black and Hispanic organizations that had to wait a couple of years to get funding for their projects and their communities to serve their constituencies, while developments got funded in suburban areas and ended up with maybe 5 or 10 percent of their units actually housing minorities.

So we have to look at where the population is that we are seeking to serve, where housing can be created or rehabilitated that will serve that population most efficiently and be realistic about local markets again.

I think a lot of this can be determined most efficiently locally.

Mr. Baskin. I'd like to respond on construction costs. I'm not an expert on construction. They look to you about three times as high as what you may see in Florida.

Obviously, first, when I think you're talking about a 650 square foot unit, that's probably the average size over the whole project.

Senator Graham. Well, there are three types of section 8 homes. There's a 540 square foot one-bedroom. There were 25 of those. Then there were eight 760 square foot, two-bedrooms, and twelve 1,150 square foot, three-bedrooms.

If you average those for a weighted average, it may be a little more than 650. But you're talking about somewhere close to 100.

Mr. Baskin. Mr. Baron said something about those being the same as the market rate units, and you said they weren't in one of your comments. But it may be that this cost is for the whole project and not just the subsidized units.

It's also gross square footage versus net in your construction costs. In the Brewery there may be a lot of additional space that isn't put in the net. But there's no question that, in order to meet the requirements of Federal programs which the Congress has passed for good reasons, it does cost more in these programs.

One of them is basically you have to pay minimum wages; in strong union locations, it's called prevailing wage. But it's really union wages as compared to some places in the South, for example. That can be a very different number.

Second, when I say this is what it cost to build it, as far as I know, McCormick-Baron doesn't do their own construction. There are other people that look at those numbers, like HUD, but I assume he went out and got a contractor to do this as cheaply as possible.

It was a very tight project. And one of the reasons a rehabber has to build a larger number is because the nature of the HUD process is that he has plans and specs and he's got to leave himself room in rehab because he doesn't know what he's going to run into.

And he has to bond it. You can't just go in there with a crew, as you could in conventional, and you get a crew of nonunion guys. You go in and say, well, let's see if we can fix this window. If we can't, we'll put in a new window, but if we can repair it, we'll repair it.

You can't do that in the FHA contracts. There are a lot of good reasons for that.

But there's no question it comes out more expensive. You also have to meet codes and you have political reasons, like in Chicago, where you can't use class A pipe, which is just a political thing with the unions.

But, in general, no Government official wants to be charged with creating the slums of the future. So you wind up, everybody wants to do a project they're proud of and it's done to a high standard, even though it's low-income housing.

If you really wanted to take all those people off the street, you would build a much lower level of housing that didn't meet city codes, HUD standards or anything else and all those people would be a lot better off for a lot less money. Just not the way the programs work.

Another problem, most of these projects are fairly small. It takes a very sophisticated contractor to work through all the Government regulations and to understand the forms and how the cost plus contracts work and all that.

But, the jobs are small. The big contractors are sophisticated enough to do them but they're not interested. The job is too small.

The smaller contractors generally aren't sophisticated enough to do these projects, so you don't have a lot of contractors lined up to do them.

Also, not the Brewery but a lot of these projects are scattered sites, which has much greater costs for security and supervision. The Brewery probably had some extra complicated construction; probably on a pure housing basis, it wasn't worth it.

On the other hand, the city was faced with $3 million to tear it down or else let it sit there. That was probably the rationale.

There are obviously differences in terms of climate in terms of Chicago versus Florida, in terms of the construction levels that we have to build to.

And the other problem, especially with the rehab but with any low-income housing, is you can't do it on a big enough scale now to have real construction efficiencies.

I was an advisor to the Kaiser Committee in 1968. Mr. Kaiser said: "We built 10,000 units of housing for the shipping industry on the West Coast during the War and it was very efficiently built, very cheaply."

That's fine. Don't try to build 10,000 units of low-income housing anywhere in America today. It just isn't politically possible. And you can't achieve those kinds of construction efficiencies.

So, I think this is a problem on a national scale. New York always get their reception because everybody knows they cost twice as much as anybody else, but that is one of those national problems.

Our costs in Chicago seemed very high to people in other parts of the country. Part of it is the program itself and part of it is the regional differences.

Senator **Graham**. I think you have made some good observations about the explanation of cost structure. That wasn't the essential point I was trying to make.

It was that you took a structure, this Brewery, which I can imagine a very difficult one to rehab into housing, and it was being done for reasons that transcended the issue of how to most efficiently provide housing.

And that was clearly indicated. My question is:

How should we parcel out our policy, public goals, both with clarity and with an assignment of responsibility that helps give us some assurance that those goals are really important?

And that they be done with the greatest care and efficiency?

Connie, my time is up.

Senator **Mack**. I want to just build on what you were saying. I really do share your thoughts about it.

I sensed that there was some uneasiness about the thrust that we're taking. So let me just state it from my perspective.

As I listened to the two presentations this morning about the different projects, one of the projects which I think was the brewery, again, had tax-exempt bonds. It was insured. It wasn't coinsurance but there was an insurance guarantee. There were tax credits, pre-1986 tax credits. There was UDAG and CDBG.

All of that, I mean, this was a major effort, they almost had to go out and encourage somebody to come in and do this.

And it seemed like that the end result was:

OK, I'll tell you what. If you all will do this, if you can just put 45 units of low-income housing in there, then I think we can get this project done.

That, to me, and this is being looked at as, you know, this is a good example of what we're accomplishing. I'm not taking any shots at the developer. It's a question of priorities, it seems to me.

I can only tell you, having spent the last 6 or 8 months traveling around my State looking at public housing authority projects, conventional housing type things, housing for the elderly, section 8 projects, going in and talking with the families—when we say families, frankly, there are very few families in the traditional sense—and you start talking to the people that are in there and seeing the difficulties and problems that they're experiencing, I can't help but kind of come away with the feeling that having these very scarce resources being drained away for the satisfaction of, quote, "community redevelopment," and I don't mean to put it down, but I would rather spend the money to see 160 units being constructed for the low-income families than seeing the project that may turn out to be from a number of points of view the exemplary project, but it's helping fewer people at higher cost.

And I guess: what's wrong with my thinking that I've just thrown out.

Ms. **Melkonian**. Well, to go back to the original point, and I think you're following it out, what should be the use of public resources? Should they be narrowed to only housing——

Senator **Graham**. If you'll insert the word "Federal public resources".

Ms. **Melkonian**. OK. What should be the use of Federal resources? Should they be narrowed only to housing? And, of course, to fully quote the 1949 promise, it was a decent home and a suitable living environment. So the goal and the objective and the vision of the use of Federal funds was broad. It encompassed the neighborhood, the community and the environment that people live in. One can't really be detached from the other.

So, as an objective, we had both as an objective.

The Department of Housing and Urban Development recognized the fact that we had to care for cities as well as meet housing needs, obviously.

So we come down to the question then of, OK, how do we "prioritize" within those objectives the use of resources?

I certainly would like to see us get back into the business. We're not doing any of this now so we have a chance to say, if we come back as a Federal Government and support housing and support investment in communities and support the revitalization of neighborhoods, how should we prioritize the use of funds?

I would not suggest that we should halve the goal, cut the goal in half and say: we're only going to do housing. You guys do the rest, meaning States and localities.

Senator **Mack**. Help me out on this though. When you say we're not doing any of that?

Ms. **Melkonian**. We're not doing anything.

Senator **Mack**. I think we are doing something. We might be doing it a different way than we have been doing it in the past. It seems to me that providing a tax credit is doing something. I mean, it's a cost. There are certainly those around Washington who are arguing that that is a cost to the Federal Government.

Ms. **Melkonian**. It is. But, it's only directed at housing that's administered by States. And, obviously, it's not a direct expenditure, it's a tax expenditure.

But what I meant was, if we as a Federal Government got back into making direct expenditures, which we are not doing, I mean, these projects are interesting studies to learn lessons from for the future. They do not help us today because we don't have a Mod

Rehab Program. We don't have any production programs. We don't have UDAG programs. We don't have HODAG programs. We don't have any investment going from the Federal level to states and communities directly for housing or community development other than the block grant program. And that is administered on the local level according to rules and priorities that are hotly debated about what should be used for what.

I think those are the kinds of standards and questions you're asking about, and those should be asked.

But, the first question which has to be answered here and can only be answered at the Federal level here is, how are we going to restructure? How do we go through our own perestroika to get resources shifted from where they are now?

I don't think we have to spend more than $1 trillion, $300 billion a year for a Federal budget. I think we have to readjust how we spend those funds so that we spend them to meet housing needs and spend them to meet community development needs.

If we simply went from 1 percent to 2 percent of the Federal budget from about $12 billion or $13 billion to about $24–$25 billion and wisely appropriated and directed those funds, we would have our housing and community development problems licked in 10–15 years. And that's a fact.

But, that's a decision that can only be made here. We're just having a philosophical discussion without the resources.

Senator **Graham**. Thanks. We are about to get called for a vote. Maybe we could use the remaining minutes starting from the plateau or the valley that you say that we are in today.

What recommendations would you have for us, for our colleagues, as to where we should proceed?

Mr. **Baskin**. Let me make a simple proposal that nobody wants to listen to, but you raised the tax credit. You say, well, the Government is doing one thing, it's giving tax credits.

Somewhere between 25 cents and 50 cents out of every dollar that it costs the Government in that tax credit program actually goes to the developer to incentivize the person who really creates the housing.

And the simple thing to do is make the tax credit refundable. In other words, if I developed a housing and I generate these big tax credits and I don't have much tax that I can offset them against, the Government sends me a check for the difference.

This has been done before. It's not a new concept for the Federal Government. It would eliminate the whole syndication process, which Congressmen have been criticizing for years about these investors who don't pay their taxes and about the lawyers and syndicators and all these people who are parasites on the system. You can eliminate them.

All you have to do is to make it refundable. You get a lot more bang for the buck. It doesn't cost the Government any more, but you get a lot more money into the housing. And when HUD comes to looking at these profits that they're supposed to look at, they'll be figuring maybe the investors get 50 cents for every tax credit dollar raised. Or for every tax credit dollar that's out there.

And now they'll be able to figure a higher number than that, if they're refundable.

That's a very simple, straightforward, not philosophical suggestion.

Ms. KOLLIAS. One of the things that I would suggest is to go ahead and make some specific policy recommendations that are directed from the Federal levels or the local level in terms of prioritizing things like community development block grants.

Your example of X-amount of money being spread over more rather than less units, from a private sector standpoint, we feel the same way. We make recommendations to our local government saying:

If you have $50,000 of subsidy to help effect a low-income housing project, wouldn't you rather put $5,000 per unit if there's a gap of $5,000 per unit, into a project that's in one neighborhood versus $50,000 per unit in another neighborhood?

You've got to make those kind of decisions. But, to the extent that the Federal Government can help make some incentives and priorities in terms of allocation of money to the localities that are making those type of tough decisions I think makes sense.

And if you are targeting the investments where there's also other sources of finance, not just the local and state but the private sector investing in the community, you might be able to see more of those dollars going indirectly for the housing because the private sector, the developers and the other players in the revitalization process will make sure that all of the other various aspects of the neighborhood will take care of itself as well.

Mr. CLANCY. I think, you know, the primary lack is money. And I think what's critical is substantial dollars, new dollars for affordable housing production. I think, putting them out there in a way that, as you suggested, that incentivizes not on the development side but on the State and other public actors, States and localities, that they get more by putting up more of their own dollars, to make those go further. Whether that's designed as housing being paid for by the Federal Government and community development by localities—that may be too rigid a breakdown to really be manageable.

Getting dollars out there creating incentives, getting them out there so they can be managed at a place that carries out national policy but that is closest to local markets where the close and fine decisions about how dollars go furthest can best are made ought to be our objective.

Senator MACK. I realize that almost everyone says that we shouldn't pick one form of project, thinking of the vouchers and certificates not being the answer, you have to have kind of a combination of both of these.

But I'd be interested from your perspective which of those would you put your emphasis in. I assume that the theory behind the voucher certificate concept may be if they were long-term instead of short; from the lender's point of view, I can certainly understand the concern.

If they were long-term, would that, in fact, drive the private sector to produce more units?

Mr. BASKIN. They have to be longer and project based, which now a small percent of them are allowed to be, because, otherwise, what the banks are concerned about is that, if the tenant moves, the certificate is gone. There's no certificate automatically replacing that certificate.

So they have to be project-based and long-term. Then they might try to develop them. But, then you're back to the old section 8 program at whatever level the rents are.

So, I mean, I don't disagree with what you're saying if what it means is, first of all, what the housing policy should be is that you have a certificate voucher program that's an entitlement program, so everybody has somewhere to live. If you want to do production, if you had that, you would need to do less production because, otherwise, you're abandoning huge areas of the city and other parts of the country.

Then you'd need a direct program, which I would like to see a direct program from HUD one-stop shopping. You would get your financing and you do your housing. You don't mix it up with community development. You're saying that's OK. Then you give community development block grants to the cities to do the community development part.

And that's a three-part, nice, clear program that solves all the housing problems in the community development programs if it's adequately funded.

Senator **Graham**. To follow up on Connie's question and to use the Las Vegas example as it was discussed this morning, if the local housing authority had a pool of money and the standard against which it was going to be evaluated was how many families in this community who meet the economic eligibility standards did you get housed, that would create an incentive for them to try to find the most efficient way of accomplishing that objective.

If they could house 500 families through an expansion of section 8 certificates as opposed to housing 160 families for the same dollars by rehabilitating an old apartment building in a community that already has a high percent vacancy factor, they would have that incentive.

The gentleman indicated that he would be inclined to accept that. In that case, why would it not be wise to encourage that local housing authority to find those surplus units in the community and to enter into long-term relationships with the owners of existing housing, saying:

I'm going to sign you up for five or 10 years and over that period of time, I will place a section 8 qualified family in this unit and here is the financial arrangements under which we'll be operating.

It seems to me that, in a community that had a surplus of housing, that would be a desirable circumstance for the landlord to have that assurance of a guaranteed income. And it would make optimum use of the housing stock that is already in place without having to go to excessive costs to develop new or rehabilitate old housing.

I accept the principle that the whole premise of that rationale is that there is that housing.

Mr. **Baskin**. I believe the man from GAO said he didn't know what the condition of that housing was. For example, the 106 units that were being rehabilitated didn't meet the standards of the certificate program.

Also, some landlords don't want to take section 8 certificate holders; just because there's a vacancy doesn't automatically mean that the units were available to the housing authority.

Marilyn had another kind of a comment.

Ms. MELKONIAN. The logic is impeccable in terms of housing people immediately in a soft housing market where rents are within the existing certificate program limit. It is an efficient and effective way to provide affordable housing.

But it's not cheap. OK? You are spending, let's say, on average—the national average is about $5,000 per unit so that over a 15-year period, you are talking about at least $75,000.

I think what I'm trying to say is that it's a multilateral strategy for meeting America's housing needs over the long run. Assuming that housing costs continue to rise; and, that we will continue to have a third of our households at $15,000 a year or less, meaning that the maximum they could afford is $375 a month, that you've got to be able to have housing that's available at that amount in order for them to afford it out of their own pocket, or else you have to subsidize.

And an income subsidy is fine. The problem is that the cost of the stock is going up and incomes are not rising as fast.

And the lower cost stock, housing that costs $375 per month or less, is shrinking and has been shrinking for the last 20 years. Millions of units have gone out of that affordability level—because of demolition, because of rising maintenance and operating costs, because of failure to produce new housing that costs that little, which is where public investment came in.

There is no market dynamic that is going to change that, so you're having a contracting supply of low-cost housing. You can meet it by doing just what you're saying: raise incomes. That is going to be a very costly strategy over time. Or you can begin slowly, over time, to build an affordable housing stock using the new entrepreneurs that Pat Clancy and the others have been talking about.

We're so far at the bottom that we really have a chance to rebuild a new system.

There's a line in Pat's testimony I think is very important. He says that we can further the trend for the expansion of what he calls the nonprofit sector and what I call the new housing entrepreneur or the new enterprise corporation in housing, "that will bring us closer to the day when we have a large-scale national industry that is utilizing public resources for the public purpose in the production of affordable housing on a scale commensurate with the need."

So that we must, if we recognize these facts, produce, in my view, a housing industry with public investment that has the ability to marry public purpose with entrepreneurial activities and to do that successfully. In terms of a recommendation for what should we do for the future, I would say, we have to rebuild. We have to look at where we are, which means that we have to rebuild HUD as an organization if only because we have 2 million units in private ownership that it is responsible for. And 1.4 million of public housing that it is responsible for.

We need a strong HUD. We can begin to invest again in the housing supply, mostly working through states and localities, and we can encourage this new breed of housing entrepreneur possibly through the tax program.

One suggestion I made in my testimony was that we permit these corporations, which I would call enterprise corporations, to be free of taxation, at least up to a certain level of capital accumulation, so that they can grow stronger as organizations that would be the recipients of public funds to build affordable housing and not indulge in the excesses that you have been so concerned about.

But we have to begin now to do that. We took 10 years to destroy what we had, so it will take us at least that long to rebuild it.

Mr. CLANCY. Just a brief note on where there is a surplus of housing. I think there's a possibility of combining what we call the sort of production approach as opposed to the certificate or sort of income subsidy approach.

We've begun to look at that in Massachusetts where we do have some real estate that was designed for a higher market and is now not reaching that market. And that is take it out of the private speculative ownership so that you don't have an income subsidy cost that is going to grow over time.

But use income subsidies, use certificates, use financing and public support to acquire units in a condominium complex or acquire buildings that have been foreclosed on by a bank as opposed to building new ones. Sometimes, those costs can be cheaper and that can be a cost-effective way in the short-term of using more of an incomes approach but also controlling the long-term costs by having the ownership of the housing become basically controlled and available for the long-term as affordable housing.

Senator GRAHAM. Just one further question in reaction to a comment that the certificates or vouchers should be long-term so that the lender will know that there's sufficient income to back up the project when a conventional—and I'm talking about now a private sector—private individual is going to build a 200–300 unit rental complex that is not designed for low income.

There is no long-term guarantee when the lender makes that kind of a loan, is there?

Mr. BASKIN. He does a market study and makes a judgment as to whether the market will be there. We're talking by definition about projects where the market studies show there is not a market there, that the private market will not pay enough rent to support the mortgage.

That's why he needs the subsidy. And I'm saying I think it's response to a question of lending or production. It has to be long-term and project-based if you want to induce production. If you want to house families in the short-term, then the program the way it is is fine.

Senator GRAHAM. Let me ask a couple of final questions.

One, unfortunately, we're now faced with the situation of some major Federal agencies, some old ones like HUD, some new ones like RTC, with mammoth amounts of assets in their portfolio.

Do you have any ideas of how those agencies and their assets might be used creatively to help us better house low and moderate income families?

For instance, Mr. Clancy, in Boston, have you had a chance to look at the assets that RTC possesses and do they have any potential for low and moderate income families?

Mr. CLANCY. RTC does not have, I don't think, any, or at least any significant assets in Boston yet. They probably will before too long.

Senator GRAHAM. The day may come.

Mr. CLANCY. However, we have gotten involved sort of pre-RTC- and I think some of the same approaches would apply with banks that have ended up owning properties through foreclosure and basically trying to design a win/win strategy, a strategy where they can look at a return that is going to be as much as they're likely to get in short order through just dumping the property on to the marketplace by working with a local community development corporation, taking a longer period of time to amass some resources, whether it's tax credit investment capital or certificates through the local housing authority, some combination of support resources that then make that housing more affordable than was the initial intent. So that kind of effort which we're now doing with private banks can definitely become a part of what RTC can do.

There is a time component to it. I think, as we've all described, the kind of complex financing for long-term affordable housing takes a long time to piece together.

And to the extent that RTC ends up in a mode of dumping the assets, that will be in direct conflict with trying to leverage those assets for more affordable housing.

Senator GRAHAM. The last question I have is, if we had as an objective to try to begin to move the numbers toward more ownership of homes among persons who either now or in the past had been in the low and moderate status, what strategy of how to go about building housing would most lend itself to eventually those persons in that housing, the coming owners either of that particular unit or some other unit?

Ms. MELKONIAN. I think there's one very simple strategy, hard to accomplish, but that's bring down interest rates. Right now interest rates are say 10 or 11 percent. My parents bought their home with a 4-percent mortgage. The difference on a $60,000 mortgage is that, at 11 percent, you need about $23,000 to afford it, and at 4 percent, you need about $11,500.

You find a way to do that and you'll house or will make homeowners of the two million American families who are not homeowners today who would have been if the trends of homeownership had stayed the same as 10 years ago.

Homeownership is going down. People under 34 years of age, families in that age group, the homeownership rate has dropped significantly. And it's I think largely due to that one policy.

Ms. KOLLIAS. To go back on that, we are very concerned about ownership in the District, which is the affordable cost of a house is well over $100,000 and actually our inventory is not single-family, detached properties like in many other places, but garden apartments. So we work with nonprofit sponsors to do limited equity co-ops and that being able to do blanket mortgages on limited equity co-ops, where a group of families together can own a property, accomplishes, you know, a piece of the American dream in terms of ownership, but also addresses the issue of keeping permanent affordability of structures in place, which is also critical.

In addition, this goes back to a national policy direction in terms of the Federal sources that go through the local governments. It's to encourage local governments to try to come up with matching Federal sources to do downpayment assistance programs, because if you can provide downpayment assistance programs for low and moderate income families, particularly first time home purchasers, then they'll be able to get some of the more traditional mortgages, but at a lower loan to value which would allow ownership as well.

Mr. Baskin. I agree with the limited equity concept as far as keeping housing in the low and moderate income housing stock for the long-term. All these programs that give somebody a house with a big break up front and then they just make a windfall when they sell it, that doesn't solve any long-term problem.

Beyond that, I would like to sort of be a devil's advocate and wonder whether poor people don't have enough problems without the burdens of homeownership.

I bought my first home a little bit after the 235 program was passed and I couldn't imagine how some of the people that benefit from that program could deal with homeownership.

One of the things people forgot to tell the assessor: that these people can't afford the normal taxes to be paid by that kind of bricks and mortar.

And the idea of selling people public housing units, which is the worst housing in the country, I think is not going to do anybody any good. Limited equity co-ops. I was principal of a company that managed practically all of the limited equity co-ops in Chicago in the early 1970's.

There were a few thousand units and I have to say that I don't think those people have the same feeling of homeownership that you normally think of with home ownership.

First of all, they couldn't benefit from the increase in value to any real degree. And our experience as a management company was they didn't have a landlord to be managed so they were mad at the management company or at their own board of the co-op.

I don't think it's the same as your image of homeownership when you have a limited equity co-op. It may be in some cases, but it's real tough. And I'm not sure that that's an appropriate goal. I think it's an appropriate goal to get people to an income point where they can afford to be homeowners. And that's great. That's very important.

But, to do it at a point where they can't afford it and without a lot of assistance and not more than just financial assistance I'm not sure is a good idea in the first place.

Mr. Clancy. I would agree that the collective nature of the kind of resident ownership—something that we've worked on with limited equity cooperatives—is more realistic and appropriate way in many instances of providing low income residents a stake in their housing.

But, beyond that, I would say that it's a question of the larger management of the environment and support services, education, job training and the other things that is critical to low-income families having more of an economic stake over time and that is critical to getting them out of the lack of resources that they now face.

Senator GRAHAM. Senator Mack has been stimulated by your answers.

Senator MACK. We keep telling you we're going to cut this off, and we keep going.

One comment that, again, just drawing on my recent experiences, I think that your comment with respect to homeownership taken in the general and very broad and speaking of the poor as if it were a monolithic class probably is true.

But I think at least, again, what I have seen, when you go out there, there are many different types and levels of education. Those who have jobs and don't have jobs. I mean, there are people out there who in fact can take advantage, in fact, if we had a 4 or 5 or 6 percent interest rate, would do very well as homeowners.

If we ever created the impression that we are going to change the public housing thrust in this country away from providing assistance to everyone owning their own home, I think that's certainly not the perspective that I come from.

But I think we should be looking for ways to assist those who can. And I can handle those responsibilities to make it available to them.

Number two, when you mentioned the thing about interest rates, there's an entire discussion we could have for another afternoon. We talk about affordability or affordable housing and the concept that we're talking about low-income all the time, but there's a huge part of our society that people don't think of as being low-income, that basically are struggling to find a way to participate in the American dream of home ownership.

I'm just curious, and the reason I'm asking this is it's out there. One of the four of you must know about it. Has anyone done a study as to what really has increased the cost of housing in this country?

Interest rates, certainly that's one.

Ms. KOLLIAS. Acquisition, whether it's existing stock of land, has really gone up.

Senator MACK. Then I would assume that's related somehow to zoning requirements or to growth management program?

Ms. KOLLIAS. And the market. Lack of space. Lack of available product or land. And, in zoning, yes.

Senator MACK. In parts of our State anyway, there are specific requirements as to whether land can be used or can't be used. And I would assume that drives it up.

What I'm getting at is has anybody out there done a study of what the various factors are that have impacted the cost of housing? And the reason I'm asking is a developer was in my office a couple of years ago concerned about the Tax Reform Act of 1986 and the treatment of utilities. In the words, they used to put the utilities in and transfer them to local communities.

Under the new act, 1986, that transfer is treated as an income. Therefore, it's increased the cost of that lot by some $3,600 or $3,700 just because of the change in the tax law.

I assume the environmental regulations have had an impact on housing. And I'm getting curious. Is there any information out there that would be helpful to us from that perspective?

Mr. BASKIN. I think a lot of studies have been done. I was reading a couple just in the last week. One which says the price of housing hasn't gone up and that over some relevant 10-20 year period, the only increase of the cost of housing is due to the fact that houses today are bigger and have more amenities and so they cost more in constant dollars, but that's because you're getting more.

So you can find almost any reasons that you want. The reasons often given tend to be codes—exclusionary zoning, communities that want large lots and want to keep people out and restrict the supply. And that keeps the values up.

But you can find almost any answer you want in the studies that are out there. Obviously, interest rates I believe are the biggest single factor.

Ms. MELKONIAN. I would agree with what Shelley said; relative to the size of homes, the National Association of Home Builders argues that the cost of housing has not, in fact, increased.

Senator MACK. Wait a minute. I can tell by the smile on your face you don't agree with that.

Ms. MELKONIAN. In the Washington, DC area, the median price of a home is $133,000. That's certainly not what it was 10 years ago. I don't know whether they've gotten bigger or whatever.

Mr. BASKIN. In constant dollars, Washington is a big exception anyway. Fifteen years ago, everybody was worried about whether anybody would pay anything for a house in Washington.

Senator MACK. It's not exactly what I'm looking for.

Ms. MELKONIAN. Again, I think it's tinkering around the edges as to zoning and all the costs of materials and so forth.

The big issue is the financing system.

Senator MACK. Should we go back to a system where we have a savings, a subsidy in savings to where there was a fixed rate on savings in this country? Because as a result of that pool, there were dollars available at fixed rates for long-term that said——

Ms. MELKONIAN. I think we have an opportunity here in this savings and loan situation which we may in fact be missing.

We're spending enormous amounts of money. The first line in the FIRREA Act is that this is all being done to preserve a system of affordable housing finance. And I don't know where the leadership is to make sure that that is in fact the result of spending $200-300 billion of our funds.

I think we have to get the financial wizards of this world, like the Bill Simons and the Lou Rainieris and others who are on the outside looking inside the system to see how they can make profits, inside this reform program, to see how it can be played out to a public purpose.

I think this is one of the areas which requires real public leadership and attention because of the magnitude of the investment that we're making.

Senator MACK. OK.

Senator GRAHAM. Good. Thank you very much. It was an extremely instructive afternoon and day. If I could ask we might from time to time solicit your further opinions as we get to a point that we're prepared to make some recommendations.

Thank you.

[Whereupon, at 4:40 p.m., the committee was adjourned.]

[Additional material supplied for the record follows:]

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

DONALD W. RIEGLE, JR., MICHIGAN, CHAIRMAN

ALAN CRANSTON, CALIFORNIA
PAUL S. SARBANES, MARYLAND
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ALAN J. DIXON, ILLINOIS
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LAMAR SMITH, REPUBLICAN STAFF DIRECTOR AND ECONOMIST

United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, DC 20510-6075

March 6, 1990

Mr. William Tanker
Vice President of Underwriting
Benton Mortgage Company
P.O. Box 19803
Knoxville, TN 37939

Dear Mr. Tanker:

Thank you and Mr. Coe for testifying on behalf of Benton Mortgage Corporation before the HUD/Mod Rehab Investigation Subcommittee on February 27, 1990 regarding the Sierra Pointe project. Your testimony, as co-insurer on the project, was most helpful to the Subcommittee's understanding of how the project was financed.

During the course of your testimony, I asked you a number of questions regarding the fair market rent for the project and how the rent was calculated. At that time you offered to provide the Subcommittee with additional information to help us understand how the contract rent was justified (See page 109 of the transcript). The Subcommittee also solicited your comments upon the figures used by the General Accounting Office in its presentation (Page 119). We also specifically requested that you provide the Subcommittee with specific recommendations regarding the restructuring of the co-insurance program (Page 123). Finally, you mentioned that you had been unable to get rent information or expense information comparables from HUD unless you submitted a Freedom of Information Act request (Page 134). Please provide the Subcommittee with any correspondence between Benton Mortgage and HUD relating to such requests and response.

In order to complete the hearing record, the Subcommittee would appreciate your response to these requests as soon as possible.

Again, I thank you for appearing at our hearing. If you have any questions, please call Jeannine Jacokes or Bill Leary at 224-6166.

Sincerely,

Bob Graham

Bob Graham
Chairman

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March 13, 1990

The Honorable Robert Graham
United States Senator
Special HUD Investigation
  Subcommittee of the Committee
  on Banking, Housing and Urban Affairs
902 Hart Senate Office Building
Washington, DC 20510

Dear Senator Graham:

On behalf of Benton Mortgage Company (BMC), we again want to thank you for the opportunity to testify before your Subcommittee on both the Sierra Pointe development and the Coinsurance Program. We would also like to thank you for allowing us to meet with your staff and present our response to the various allegations raised in HUD's Office of Inspector General Audit on the Sierra Pointe development. Since we have not been allowed a similar forum with HUD, we appreciated your staff's concerns and willingness to listen and understand all sides of the issues. We really feel that both sessions have been valuable, and we remain available to meet with you or your staff to discuss housing issues in general, or the coinsurance program in particular.

In response to the specific questions raised in the hearing and in your follow-up letter, we would like to address the following issues: (A) Benton Mortgage Company's derivation of Sierra Pointe's processing rent (using the 2-bedroom rent as an example); (B) the reason for the difference between BMC's processing rent and the GAO's estimated average rent; (C) recommendations regarding the restructuring of the coinsurance program; and (D) BMC's unsuccessful attempts to share information and receive guidance from HUD on coinsurance and related issues.

A. BMC's Derivation of Sierra Pointe's Processing Rents

Benton Mortgage Company (BMC), like all coinsuring lenders, is charged with the responsibility for determining the processing rents (only) to be used when computing the feasibility of a coinsured apartment project. The primary handbook for use in the processing of a 221(d)(4) project is Handbook 4561.1 Coinsurance for Mortgage Lenders (Section 221(d). Chapter 9, Valuation Processing, defines the purpose of Valuation Analysis as:

> "A. Purpose. To evaluate the property as a security for a long-term coinsured mortgage."

The chapter also defines what constitutes an acceptable risk for HUD under the Coinsurance Program:

> "1. Acceptable Risk
>
> a. The analysis must show a reasonable expectation that project income will, for the duration of the mortgage term, be adequate to;
>
> - properly maintain the property
> - pay all required project expenses
> - meet debt service requirements and provide a reasonable return to the owners' equity investment."

Within the above-defined context of Purpose and Acceptable Risk, the chapter contains two separate sets of instructions pertaining to the derivation of processing rents: one for market-rate projects, and one for Section 8 Moderate Rehabilitation assisted projects.

The instructions for deriving processing rents for a market-rate project are:

1) "Estimate unit rents per month based on and supported by current market rates for similar units in comparable projects furnishing comparable services in competing areas";

2) "You must not use rental data on subsidized projects";

3) "...Make adjustments on a rent comparable analysis sheet (Form HUD-92273)"; and

4) "Trend the estimates to two months beyond the projected construction completion."

The instructions for determining rents for a Section 8 Moderate Rehabilitation assisted project are defined in Chapter 9, Section 9-15 as:

> "Rents. In processing rehabilitation cases with Section 8 Moderate Rehabilitation funds, the rents will be determined by one of two methods:
>
> 1) Market Rents or
> 2) Market Rents plus up to 20 percent if required for feasibility (only applies to Section 8 assisted units). Feasibility refers to the maximum rent required to have the debt service criteria equal the controlling mortgage criteria."

As is evident from the very limited instructions as to processing Section 8 projects (and an absence of any references to the Moderate Rehabilitation Handbook) that HUD did not clearly delineate the procedures to be utilized by themselves, the local housing authority, or the coinsurer in the determination and relationship between coinsurance processing rents and Moderate Rehabilitation Section 8 rents. It is this lack of clear and concise instructions which we believe caused much of the confusion in the interrelationship between the two programs. Assistant Secretary Demery in a letter dated July 29, 1987 to Ms. Lynda M. Murphy, (attached) echoed this assertion by stating: "As you are aware, problems have developed in the combined use of Coinsurance and Moderate Rehabilitation assistance because definitive instructions in this area are lacking. The instructions contained in Section 9-15 of HUD Handbook 4561.1 for 221(d) Coinsurance are not adequate and no instructions for 223(f) have been published." (underlining added).

When preparing his analysis and determination of processing rents, BMC's contract appraiser:

1) Chose four different apartment developments which, in his professional opinion, were comparable to an after-rehabilitated Sierra Pointe, non-subsidized, and located in competing areas. Unadjusted and untrended rents in these developments ranged from $435 to $619 per month, with a mean rent of $541 (for two bedroom units);

2) Adjusted the rents for differences in development and unit characteristics such as age, size, condition, and for the combination of utilities not included in the rent. Following these adjustments the rents ranged from $420 to $521;

3) Selected a Correlated Subject Rent, $465;

4) Trended the Correlated Subject Rent to $483;

4) Added the 20% Section 8 adjustment, thereby deriving a processing rent of $580.

Upon submission to BMC of the contract appraisal, it was thoroughly reviewed by BMC's HUD-approved Review Appraiser. The role of the Review Appraiser is not specifically outlined in the Handbooks. However, in keeping with industry practice, BMC's Review Appraiser supervised and reviewed multifamily appraisals to assure that the appraisals were consistent with FHA guidelines, and that the resultant processing constituted an acceptable risk as defined in the HUD handbook.

BMC's Review Appraiser reviewed the entire appraisal, and in regard to rents:

1) Further reduced appraised unit rents for differences in development and in unit characteristics. Following these adjustments, comparable rents ranged from $350 to $474;

2) Selected a Correlated Subject Rent in accordance with HUD's instructions as printed on the rent form "92273-Estimates of Market Rent by Comparison". These instructions say that:

> "If prevailing vacancy rates are lower than 5%, indicating a tight rental market, the correlated subject rent should be derived from the high end of the range of the indicated rents from Line 19"

The Review Appraiser based his compliance with these instructions on studies compiled by the University of Nevada, Las Vegas (UNLV), and by Coldwell Banker. The UNLV study indicated that the vacancy rate in the subject's zip code was only 3.4%, while the Coldwell Banker study indicated that the vacancy rate was approximately 5%. Additionally, the Housing Authority had indicated to BMC that it had a waiting list of approximately 700 persons and families eligible for assisted housing. The HUD Regional Economist, in his review for the HUD Director of Housing Development reported that "The Clark County PHA has indicated that there are as of October 1, 1986 about 525 households on their waiting list for assisted housing. For the City of Las Vegas the figure is 576.". Therefore, a low vacancy rate coupled with a demonstrable need substantiated the Review Appraiser's selection of a Correlated Subject Rent of $470;

3) Trended the Correlated Subject Rent to two months following construction (rehabilitation) completion: $497;

4) Computed the Section 8 adjustment, thereby deriving BMC's Processing Rent of $596.

Upon review of all of the input and computations BMC used to determine processing rents, HUD Approved The Rents.

Finally, for clarity, it is necessary to reiterate that: A coinsuring lender is not a party to either the Agreement to Enter Into a Housing Assistance Payments Contract (AHAP) or a Housing Assistance Payments Contract (HAP). Coinsuring lenders do not, and cannot set Moderate Rehabilitation Section 8 rents. In the case of Sierra Pointe, HUD's Office of Inspector General specifically supports this statement by saying: "The Authority signed a HAP Contract which established the rents for Sierra Pointe" and "...the ultimate responsibility for moderate rehabilitation rent determinations is with the Authority." (Report on Housing Authority of Clark County, Nevada, Section 8 Moderate Rehabilitation Program Las Vegas, Nevada, 89-TS-203-1004, March 10, 1989.)

B. Difference Between BMC's Processing Rent/GAO's Estimated Rent

In contrast to the above-described HUD approved rent computation process, the GAO derived its estimated rent of $425 by arithmetically averaging selected current rents which could have been used by certificate holders in the county. Further, the GAO indicated that the vacancy rate data used in their study was developed by the Federal Home Loan Bank Board in San Francisco, as opposed to the localized data generated in Clark County by UNLV and Coldwell Banker and used by BMC. According to the Housing Authority the actual maximum rent available for use by certificate holders at the time was $524 per month. As is evident from the previously noted BMC arithmetic average, both BMC and the GAO are in general agreement as to an averaged rent level for standard, unrehabilitated units at the time. The Correlated Subject Rent of $470 utilized by BMC is an approximate midpoint in the rental range of $425-$524, and we believe that this rent reasonably reflected the increase in rental value expected to be brought about by the rehabilitation. Further, in compliance with HUD guidelines, this rent also reflects the strength of the unsubsidized market and the demand for assisted housing as indicated by the vacancy rates and waiting lists. Therefore, had the GAO completed their analysis following the HUD prescribed format (consideration of the proposed improvements, trending to two months past construction completion, and adding the Section 8 Moderate Rehabilitation adjustment) we believe that both BMC and the GAO would remain as they started-in substantial agreement as to rent levels.

C. Specific Recommendations for Restructuring and Improving Coinsurance Program

The next area we would like to address concerns specific recommendations for restructuring and improving the coinsurance program. We have attached as exhibits a letter written to you from Fred Benton, and a letter written to Mr. Peter Monroe at HUD from Tom Ford detailing their recommendations. Additionally, we would like to recommend:

- Revive the coinsurance program in conjunction with a fair-shared rental assistance program as a vehicle for financing only developments for persons and families of low income. Middle and upper income projects have other financing vehicles available to them such as FNMA and conventional financing, lower income projects generally do not;

- Give developers a continuing financial stake in the project, i.e., the first 5% of any loss, so as to guarantee developer vigilance for the well-being of the tenants and the fiscal security of the development;

- Require developers to formulate and submit an Affirmative Drug Education/Security services plan as a part of all full insurance and coinsurance applications, to be coordinated and approved by HUD in conjunction with other appropriate Federal, state and local agencies;

- Include access to Job Training/Job Placement services as a coordinated program through HUD for these coinsured projects;

- Include Day Care services within (or coordinated between) coinsured projects so that single parents have an ability to pursue employment and training opportunities;

- HUD should develop guidelines and procedures for determining rents and computing up-front equity requirements which recognize actual and anticipated syndication proceeds (tax-credit or otherwise). These procedures should encompass both HUD's processing of full insurance mortgage loans, and private lenders' processing of coinsured loans; and finally,

- HUD should develop clear, concise and definitive guidelines for the program so that all participants have the same understanding of the program from the start. We believe this would help to avoid the retroactive confusion and misinformation plaguing the current program. Further, HUD program staff should seek to develop and implement monitoring and control procedures, both to assure lender compliance with program requirements, and to assess the effectiveness of the program in meeting policy goals.

We offer these recommendations to you because we feel that coinsurance has proven itself to be a valuable, cost-effective and reliable tool for supplying capital to the low income housing market. Additionally, we strongly believe that HUD, HHS and other Federal, state and local agencies must coordinate their individual programs into a coherent housing and social services policy, if we as a nation are to ever be successful in reclaiming our inner cities from their current slide into economic and social desolation. Coordination of housing, education, employment and drug education/enforcement policies (as outlined above) will allow the Congress to most efficiently allocate our increasingly scarce resources into an efficient tool for solving these growing problems, and a coinsurance program - targeted for low income families - will unquestionably constitute a strong and successful foundation for this tool.

D. Unsuccessful Attempts At Information Sharing and Receipt of Guidance

Our final comments in this letter pertain to our numerous attempts to solicit and to share information both from and with HUD. As we mentioned during our panel's testimony, BMC staff met with a HUD official in the Office of Insured Multifamily Housing Development and suggested that we (HUD-BMC) share rental and expense information, perhaps via an electronic data base. We were told that this sort of information sharing was not possible and in fact, if we wanted HUD's information we would have to submit a Freedom of Information Act request. On other occasions, our staff architect verbally requested information regarding building costs from various HUD offices and was refused such information. Finally, as we stated in our testimony, another official in HUD's Office of Insured Multifamily Housing Development told us that due to the way that HUD prioritized field office employee time and assignments, an employee could actually receive "demerits" for meeting with us to discuss rental or expense data. Unfortunately, all of the above examples represent verbal communications with HUD. For your information, we have attached various examples of written correspondence for which we have never received an answer, or, for which we did not receive an answer on a timely basis.

In conclusion, we believe that the forums provided by your Subcommittee and your staff are extremely valuable, because they allow both the public and private sectors to work in concert to find solutions to the affordable housing crisis. As our Company history shows, everyone at Benton Mortgage Company is philosophically commited to helping to house low-income Americans. Therefore, we thank you and your staff for your attention to this very important issue, and we look forward to the time when our mutual efforts will provide a viable solution.

Respectfully,

William H. Tanker

William H. Tanker

Thomas E. Coe

EXHIBITS

A

A) Senator Graham's Letter to BMC

B) Form 92273

C) Demery Letter

D) Policy Recomendation Letters

E) Letters from BMC to HUD - Late Response

F) Letters from BMC to HUD - No Response

B

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
HOUSING—FEDERAL HOUSING COMMISSIONER

ESTIMATES OF MARKET RENT BY COMPARISON

1. UNIT TYPE: 2BR
2. SUBJECT PROPERTY: SIERRA POINTE

A. ALPINE VILLAGE, LAS VEGAS NEVADA (ADDRESS)
B. LAS PALMAS, LAS VEGAS NEVADA (ADDRESS)
C. PACIFIC HARBORS III, LAS VEGAS NEVADA (ADDRESS)
D. RANCHO SAHARA, LAS VEGAS NEVADA (ADDRESS)
E. (ADDRESS)

CHARACTERISTICS	DATA	A. DATA	A. ADJUSTMENTS −	A. ADJUSTMENTS +	B. DATA	B. ADJUSTMENTS −	B. ADJUSTMENTS +	C. DATA	C. ADJUSTMENTS −	C. ADJUSTMENTS +	D. DATA	D. ADJUSTMENTS −	D. ADJUSTMENTS +	E. DATA	E. ADJUSTMENTS −	E. ADJUSTMENTS +
3. Eff. Date of Rental	8/86	8/86			8/86			8/86			9/86					
4. Type of Project/Stories	WU/2	WU/2			WU/3			WU/2			WU/3					
5. Year Built - EFFECTIVE AGE	1980	1978			1978			1985	15		1986	15				
6. Sq. Ft. Area	625	960	40		1,000	45		978	45		1000	45				
7. Number of Bedrooms	2	2			2			2			2					
8. Number of Baths	1	2	15		2	15		2	15		2	15				
9. Number of Rooms	4	4			4			4			4					
10. Balc./Terrace/Patio	-	+	10		+	10		+	10		+	10				
11. Garage or Carport	-	+	5		+	5		+	5		+	5				
12. EQUIP: a. A/C	+	+			+			+			+					
b. Range/Oven	+	+			+			+			+					
c. Refrigerator	+	+			+			+			+					
d. Disposal	+	+			+			+			+					
e. Vent Fan	+	+			+			+			+					
f. Dishwasher	-	+	10		+	10		+	10		+	10				
g. Carpet/Drapes	+ -	+ +	5		+ +	5		+ +	5		+ +	5				
h. Pool/Rec. Area	+ -	+ +	10		+ +	10		+ +	10		+ +	10				
13. SERV: a. Heat/Type	- G	- E			+	20		-			-					
b. Cook/Type	- E	- E			+	10		-			-					
c. Electricity	-	-			+	15		-			-					
d. Water Cold/Hot	+ +	+ -		10	+ +			+ -		10	+ -		10			
14. Storage																
15. Project Location									15							
16. Other - FIREPLACE																
17. Unit Rent Per Month		435			619			593			515					
18. Net Adjustment w/o Trend and Spec. Adj.			-85			-145			-120			-105				
19. Indicated Rent w/o Trend and Spec. Adj.		350			474			473			410					

NOTE: If prevailing vacancy rates are lower than 5%, indicating a tight rental market, the correlated subject rent should be derived from the high end of the range of the indicated rents from Line 19.

20. Correlated Subject Rent	410
21. Occupancy Date 1/88 Trend 4 % [illegible]	37
22. Subject Rent With Trend	447
23. Spec. Adjustments	
a. Mgt./Amen. SEC. 8 %	
b. Financing 30% %	99
24. Adjusted Subject Rent	596

SECTION 8 PROJECTS ONLY

	W/O DIRECTOR'S ADJUSTMENTS	W DIRECTOR'S ADJUSTMENTS
25. Mtg. Ins. Processing Rent		
26. Sec. 8 Rent Estimate (Include financing adjustments, if appropriate)		

REMARKS

THE PROPOSED CONTRACT RENT OF $596 IS REASONABLE FOR ALL TWO BEDROOM UNITS.

THE RENTS HAVE BEEN PROCESSED IN ACCORDANCE WITH PARAGRAPH 4-15 OF HUD HANDBOOK 4561.1, INCLUDING THE ALLOWABLE SECTION 8 ADJUSTMENT.

THE GROSS RENTS ARE WITHIN THE APPLICABLE FAIR MARKET RENT LIMITATIONS.

*: In the adjustments column, enter dollar amounts by which subject property varies from comparable properties. If subject is better, enter a "Plus" amount and if subject is inferior to the comparable, enter a "Minus" amount. Use reverse to explain adjustments as needed.

(Signature of Appraiser)

(Date)

(Signature of Reviewer)

11/24/86
(Date)

HUD-92273 (8-78)

‡ Form 2273 which is obsolete

07/30/87 14:1''   ☎ 202 293 2739 BARRE""-MONT.&MU   02

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-8000

JUL 29 1987

OFFICE OF THE ASSISTANT SECRETARY FOR
HOUSING-FEDERAL HOUSING COMMISSIONER

C

Ms. Lynda M. Murphy
General Counsel
Multifamily Housing Association
2555 M Street, NW, Suite 100
Washington, DC 20037

Dear Ms. Murphy:

This is in response to your July 9, 1987 letter regarding the processing of projects which involve the use of both Section 221(d) or 223(f) Coinsurance and rental assistance under the Section 8 Moderate Rehabilitation program.

As you are aware, problems have developed in the combined use of Coinsurance and Moderate Rehabilitation assistance because definitive instructions in this area are lacking. The instructions contained in Section 9-15 of Handbook 4561.1 for 221(d) Coinsurance are not adequate and no instructions for 223(f) have been published. (The March 24, 1986 memorandum on "Refinancing/Purchase of Section 8 Projects Using Section 223(f)" does not apply to the Section 8 Moderate Rehabilitation program).

We are presently developing policy and procedures in this area, and appreciate the interest that you and others in the industry have conveyed to us. We have considered your recommendations in light of overall policy with regard to both Coinsurance and the Section 8 Moderate Rehabilitation program. We have no intention to deviate from present policy on the delegation of almost all responsibility for coinsurance processing to approved lenders. Neither is it our intention to diminish PHAs' authority with respect to the setting of Section 8 rents. In this context, we do see merit to the recommendation that PHAs have the authority to set Section 8 rents not to exceed one hundred percent of the Moderate Rehabilitation Fair Market Rents without prior HUD approval. Coinsuring lenders would then use these rents as the basis for setting coinsurance processing rents.

We intend to publish instructions on this in the very near future and to subsequently revise Handbooks 4561.1 (221(d)) and 4566.1 (223(f)).

Once again, thank you for your thoughts on this matter.

Sincerely yours,

Thomas T. Demery
Assistant Secretary

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D

November 8, 1989

Senator Robert Graham
241 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Graham:

Please know that I wholeheartedly endorse and applaud your commitment to revise and improve HUD's coinsurance program. While Benton Mortgage Company previously submitted a list of legislative remedies which we feel would enhance this program, I am compelled to offer additional suggestions which deal with the human side of actually living in low income housing.

First, I think that whatever programs are financed and monitored by HUD should set the standards and expectations for all low income housing. The marketplace should have to meet or exceed government standards. During the more than 20 years in which I have helped finance many low income housing projects, it has been frustrating to see provisions for low income children's needs considered unnecessary (i.e., playgrounds, on site community recreation rooms, school bus stop shelters, etc.). In my opinion, all low income housing should provide, at a minimum, safe and decent playgrounds.

Second, community security should be legislatively mandated for any project in which low income Americans live, be it public housing, coinsured or fully insured projects. Security offers a physical and psychological advantage to those low income families and individuals who are increasingly vulnerable to the terror of drugs. There is no debate about the fact that a security system deters drug involvement.

Third, there is the issue of lead based paint. While most public housing, coinsured and fully insured projects have material safety standards, I am aware that low income families who qualify for public housing vouchers frequently choose older, more dilapidated buildings in which to live. Once a child becomes brain damaged and retarded from consuming old lead based flaking paint, the child's life is not only ruined, he or she remains dependent on public assistance for life. It is my hope that in the future vouchers will not be able to be used where lead based paint exists.

All it takes is a few field trips to low income projects to witness that the needs I've mentioned are critical, humane and cost effective. The only thing standing between a playground for a low income child and a security system for a low income community is someone who cares enough to do something.

Know that I will help in any way I can. I have written to you because you are on record as wanting to introduce remedial low income housing legislation in the near future. Who knows how many years it will be before low income housing issues are again a legislative focus.

Respectfully,

BENTON MORTGAGE COMPANY

Fred D. Benton
Chairman

FDB/bjh

Benton Mortgage Company

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June 9, 1989

VIA FEDERAL EXPRESS

Mr. Peter Monroe
U. S. Department of Housing
and Urban Development
451 Seventh Street, S. W. - Room 9100
Washington, DC 20410

Dear Mr. Monroe:

Over the past five years there have been significant changes in the apartment business. The main reason for the changes was the tax bill that eliminated tax shelters. Sponsors can no longer sell tax shelters and bring in 20% to 30% of their costs over a four or five year period. Previously, this 20-30% could cover a lot of operating deficits and during the pay-in period the sponsor normally had to guarantee to the limited partners the operation of the project. Another factor that contributed to overbuilding was apartments financed with tax-exempt low floaters. In addition, the tax bill that went into effect on January 1, 1986 that changed the low income tenant requirements for tax-exempt bonds created a large number of tax-exempt financing in November and December 1985, the effects of which are still being felt in the Southeast. Add to these situations the overbuilding and subsequent collapse of the oil patch, and we are fortunate that apartment financiers aren't in worse financial shape.

During this period, we have seen an average good apartment in the Southeast decrease in value from $35,000 to $25,000 per unit; medium priced older properties from $25,000 to $18,000 and low end apartments from $15,000 to $10,000. We have seen projects that FHA Area Offices insured at $35,000 per unit be worth $25,000 when construction was completed. No one intentionally underwrote these projects thinking they would default, but the fact remains that they are defaulting. FHA needs to take the defaults into consideration when determining safeguards and procedures.

As you could see by our Tuesday meeting, there are as many solutions to the problems as there are coinsurers, each trying to better his competitive advantage by his comments. The solutions won't be easy for you, but efforts need to be made to improve FHA's security in both coinsurance and full insurance.

In 1983, when 223(f) coinsurance started, we had never done 223(f)'s so we thought we would wait until 221(d)(4) came along. We thought in 1983 that the need and demand was for new construction market rate apartments. As time went along, 1983 and 1984 were boom years for market rate apartment construction. We jumped into it in coinsurance in 1985. Our first six cases in 221(d)(4) were all market rate projects. All six fell apart because of various causes. Two or three are noteworthy. A Nashville project was denied by the Area Office because of a soft market and a Memphis project was denied because of a soft market. On a third project, we required a $3,000,000 operating deficit and the developer took the project through the Area Office with a much lesser operating deficit. Our other three projects fell apart because of developer concerns about softening markets. These circumstances, however, made us aware of the dangers in market rate projects. This moved us towards low income housing because we had previously financed through tax-exempt bonds about 300 projects over the past 15 years and had one project default.

What I am getting at here is that the program has functioned properly at times and some fine tuning is probably all that is necessary to help avert project and lender defaults.

The following will hopefully be of help to you in making these adjustments. I followed the format used at the Tuesday conference and added some other thoughts.

Lender Characteristics

1. Initial Requirements...$1,500,000. This is fine, allows smaller lenders to get in. FHA lenders have traditionally been small. But if you keep this the same, reserves must grow with each financing.

2. Growth/Increase in Net Worth - Need more money kept in reserve out of each loan, both at closing and during the life of the loan. We have been promoting this for two years. The nursing home requirements are good; they could be used for 223(f) and 221(d)(4). If they are not, we would recommend that capital stay the same, $1 for $300 and that a dedicated account should contain 1% of outstanding portfolio.

3. MIP - Lender's premium mandatory on 232 and 221(d)(4), maybe even 223(f) but you would get strong resistance. All MIP and lender's premium after taxes to dedicated account until it reaches one percent of outstanding portfolio.

4. Reinsurance - Problem. We tried to reinsure 1/2 our risk since 1985 and have been unable to do so. The insurers for 1/2 the risk want most of the fees.

5. Coinsurer Joint Risk Sharing - In favor of mandatory joint risks for all projects over over 10% of portfolio or $15,000,000.

6. Low Liquidity - 1% in dedicated account or nursing home dedicated account would eliminate low liquidity.

7. Warehouse Lines - Guarantee that if money is advanced by warehousing bank, GNMA's will be issued and the money received on delivery of the GNMA's will go to the warehousing bank.

8. Second Tier Coinsurer - This is fine with us and could help liquidity problems.

Project Characteristics

1. Underwriting/Overmortgaging - We feel you have to take some of the discretion out of the program. If the developer wants more than the rent roll will amortize, have him put up a letter of credit.

   a. Appraisal Process/Staff appraisers - don't know which is better. We have gone to staff architects to improve our architectural product, We use contract appraisers.

   b. Review Appraiser/Chief Underwriter role in appraisal process - should be different people.

   c. Floor to Ceiling Concept - In favor of floor to ceiling backed by letter of credit. This should be on full insurance as well as coinsurance.

Defaults/Workouts/Disposition

1. Default Reports - OK, however, report may give more of a bleak picture than actual case. For us it distorts the true picture. We report cases as defaults that are making money. Because we have a workout that allows the project to stay one or two months behind in payments we report as default.

2. 2530 Reporting - We need something to show us who is late or in default in addition to 2530 clearance. We don't want to make loans to people that have defaults or late payments on other HUD loans or coinsurance loans. In addition, we have a couple of borrowers we wouldn't wish on anyone.

3. Lender Tools - Regulation that requires a change in management when payment is missed. In the alternative, the sponsor or affiliated management may continue for no fee.

   - Loan management Section 8 subsidies including PBA or vouchers.

   - If we have a workout HUD will participate after lender's 5% in a 15-85 ratio.

4. Operating Loss Loans and 241 - Usually do not work; it's just more fees and expenses. A better solution would be to eliminate all benefit to owner including tax benefits; then split losses after lender's 5%, 15-85.

5. Disposition - Allow GNMA's to stay outstanding. Sell project with loan on it; this creates value if rates have gone up.

Monitoring/Early Warning System

1. 120 Day Reviews - Hopefully, they will show that things aren't as bad as some would have you believe and you can get a handle on the situation.

2. CASII/DCNS - See our letter of May 31, 1989.

3. Quarterly Data Request - Get the information and then share it with us so you can help us determine which types of loans are having problems (rehab, retirement, etc.).

4. Troubled Project Information - We try to share everything with Loan Management's Dan Raley.

It's fine to send all types of information to HUD. Please share the results of this information with us. Please share information HUD already has.

We have several other thoughts that we would like to share with you on specific problems that would take some of the discretion out of underwriting. We will send those in the next week or two.

Sincerely,

BENTON MORTGAGE COMPANY

Thomas G. Ford
President

TGF/bjh

cc: James Hamernick
Frank Brown
Steven Hans
Linda Cheatham

E

NOTE REGARDING ATTACHED LETTERS

Permission to extend this Firm Commitment comes from HUD after HUD cited our original issuance of this Commitment as a reason for extending BMC's probation and for their withdrawal of BMC's mortgagee status!

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY FOR
HOUSING-FEDERAL HOUSING COMMISSIONER

JAN 26 1990

Mr. William Tanker
Vice President
Benton Mortgage Company
P.O. Box 19803
5731 Lyons View Drive
Knoxville, TN 37919

Dear Mr. Tanker:

This is in response to your letter of September 28, 1989 requesting permission to extend the Firm Commitment for coinsurance issued to the Pecan Creek Limited Partnership for Pecan Creek Apartments (FHA Project No. 118-36609) until November 14, 1989.

The Section 8 Moderate Rehabilitation Agreement to enter into a Housing Assistance Payments contract referred to in your letter has been cancelled and the Housing Authority advised that the selection of Pecan Creek was not in accordance with Moderate Rehabilitaton program regulations and instructed to readvertise. An extension of the Firm Commitment is hereby granted until such time as the readvertising takes place and a selection made. In the event that the Pecan Creek Apartments project is selected for funding as a result of the readvertising, further extensions will be approved. Benton will be responsible to assure that the underwriting determinations set forth in the Commitment remain current.

If you have any questions, please contact Michael Winter, Office of Multifamily Coinsurance Programs, at (202) 426-7113.

Very truly yours,

Joseph E. Malloy

Joseph E. Malloy
Acting Director
Office of Multifamily
Coinsurance Programs

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September 28, 1989

VIA FEDERAL EXPRESS

Mr. James L. Logue III
Deputy Assistant Secretary
for Multifamily Housing Programs
U. S. Department of Housing
and Urban Development
451 Seventh Street, S. W. - Room 6106
Washington, DC 20410

Re: Request for Permission to Extend the
Firm Commitment for Coinsurance
Pecan Creek Apartments
Tulsa, Oklahoma
FHA Project No. 118-36609

Dear Mr. Logue:

Please accept this letter as an official request to extend the Firm Commitment for Coinsurance issued to the Pecan Creek Limited Partnership for the above-referenced project until November 14, 1989, pursuant to the attached request (Exhibit A) from the General Partner of the Pecan Creek Limited Partnership.

Benton Mortgage Company received authorization from HUD to proceed to a Firm Commitment for Coinsurance on July 14, 1989 (attached as Exhibit B). Benton Mortgage Company subsequently issued a Firm Commitment for Coinsurance and then began proceedings toward an Initial Endorsement for the development. However, on or about July 18, 1989, I was verbally advised by Mr. Michael Winter of HUD Central and Mr. Robert Jaggers from the Oklahoma City HUD Office that, due to a question regarding the validity of the Section 8 Moderate Rehabilitation Agreement to Enter into a Housing Assistance Payments Contract (previously entered into by and between the development's proposed owner and the Housing Authority of the City of Tulsa), Benton Mortgage Company was not to proceed to Initial Endorsement until we received written permission to do so from the Department. Subsequent to this conversation, I am aware that telephonic conversations and various pieces of written correspondence have been exchanged regarding this matter between the Department, the Housing Authority and the proposed owner.

Because of the complex nature of this issue and the number of variables necessarily considered prior to its (hopefully successful) resolution, it is apparent that more time will be required by your Office before a decision is rendered.

Therefore, due to our inability to move toward Initial Endorsement because of the above-described issue, we ask for your authorization to extend the Firm Commitment for Coinsurance for the Pecan Creek Apartments until November 14, 1989.

Thank you for your consideration of this matter, and please feel free to call me at your earliest convenience if you have questions or need any further information regarding this matter.

Sincerely,

BENTON MORTGAGE COMPANY

William Tanker

William Tanker
Vice President

WT/bjh

Enclosures

NOTE CONCERNING ATTACHED LETTERS

As a result of HUD's delay in responding to this letter, BMC was unable to bring this project to Initial Endorsement. Please further note that HUD did respond within one week following receipt of BMC's letter indicating our inability to participate in this financing.

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY FOR
HOUSING-FEDERAL HOUSING COMMISSIONER

NOV 28 1989

Mr. Lyn R. Williams
President
Bridge Enterprises, Inc.
4706 Glenspring Road
Richmond, VA 23223

Dear Mr. Williams:

This will respond to the April 20, 1989 letter from Mr. William Tanker of Benton Mortgage Company concerning Brookland Park Plaza, a substantial rehabilitation project in Richmond, Virginia, proposed for coinsurance under the Section 221(d) program.

You had been working with Benton Mortgage Company but it is our understanding that you are now working with Related Mortgage Corporation of New York. Prior to your leaving Benton Mortgage, they had written this office on your behalf requesting a waiver of certain provisions contained in HUD Letter 88-14 dated July 21, 1988. This letter responds to the request.

The Virginia Housing Development Authority (VHDA) has agreed to provide financing to the project (via purchase of the GNMA certificates) at a face interest rate of 6 percent for the entire term of the mortgage (presumably 40 years). At initial closing, the mortgagor partnership will pay VHDA a discount sufficient to yield a return of 8.5 percent for the first 15 years of the mortgage term. We have no objection to this, provided such discounts are not included in computing the mortgage amount. In addition, any Section 8 assistance for the project must be processed reflecting the 6 percent face interest rate.

Commencing with the 16th year, the mortgagor will be required to pay VHDA an additional 2.5 percent per year in contingent interest (from distributable surplus cash) to make up the difference between the 6 percent mortgage rate and 8.5 percent. We do not object to this provided the dollar equivalent of the 2.5 percent does not exceed 50 percent of the distributable surplus cash generated by the project, consistent with current policy in Coinsuring Lender Letter 88-14.

Your letter suggests that if, after the 15th year, VHDA sells the GNMA certificate, a purchaser will most likely buy it at a reduced price because of its low interest rate. VHDA proposes that this sale will constitute a payment event within the meaning of Lender Letter 88-14 and that the mortgagor partnership reimburse it for such loss. The plan further proposes that an actual sale need not occur in order to trigger such a reimbursement. VHDA may presume to have sold the mortgage, say in the 18th year, and pretend to have suffered a loss. This presumed occurrence will require the mortgagor to pay VHDA the full amount of its presumed loss. The obligation to pay this sum would be secured by a subordinate deed of trust. The amount payable upon an actual sale may not, in accordance with HUD policy, exceed 75 percent of the net proceeds then due the mortgagor or its partners or principals. In computing the net proceeds, the outstanding mortgage balance and any funds required by the coinsuring lender or HUD to be used for the benefit of the project as a condition of approval of a transfer of physical assets, must be excluded.

As we understand the current proposal regarding this limitation, the mortgagor and VHDA are willing to accept the 75 percent as a maximum. If 75 percent of the difference (as defined in the preceding paragraph) is not sufficient to fully reimburse VHDA for its loss and the mortgagor fails to make up the shortfall, a default under the second trust would result, allowing VHDA to foreclose, subject to the first mortgage. We pose no objection to such a provision. However, such foreclosure must be in accordance with the Department's rules regulating transactions of this nature.

Please be advised that this letter does not speak in any way to the Section 8 assistance associated with this project nor does it imply that we have reviewed or approved the processing or underwriting of this case. We would expect, however, that the rent computation, when accomplished, will reflect the 6 percent interest rate.

Sincerely,

James L. Logue III
Deputy Assistant Secretary
for Multifamily Housing Programs

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November 21, 1989

Mr. James L. Logue III
Deputy Assistant Secretary for
Multifamily Housing Programs
U.S. Department of Housing and Urban Development
451 Seventh Street, S.W., Room 6106
Washington, D.C. 20410

Re: Brookland Park Plaza Apartments
Richmond, Virginia
FHA #051-36617

Dear Mr. Logue:

On April 20, 1989, Benton Mortgage Company submitted a letter to HUD (the "Letter"), a copy of which is enclosed, requesting two waivers, and one clarification, of HUD policy to facilitate participation by the Virginia Housing Development Authority ("VHDA") in the financing of Brookland Park Plaza Apartments in Richmond, Virginia.

Benton Mortgage Company is no longer able to participate in this financing but has advised the developer, Brookland Park Plaza Limited Partnership (the "Partnership") that we will assist it in whatever way we possibly can to see this important project to fruition.

We understand that the Partnership is presently considering alternate coinsurance lenders. The Partnership has indicated to us that it intends to utilize the VHDA financing with whichever lender it selects and that a response to the Letter will be needed by that lender.

To avoid any further delays in the processing of the project, Benton Mortgage Company respectfully requests, on behalf, and for the benefit, of the Partnership that a response to our letter be sent directly to VHDA.

Please do not hesitate to call me if you have any question regarding this letter.

Sincerely,

R. Gale Huneycutt, Jr.
Vice President

cc: David F. Belkowitz
Lyn R. Williams
Harry A. Purshansky

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April 20, 1989

VIA FEDERAL EXPRESS

Mr. James L. Hamernick
Acting Deputy Assistant Secretary
for Multifamily Programs
U. S. Department of Housing
and Urban Development
451 Seventh Street, S. W. - Room 6134
Washington, DC 20410

Re: Waiver Request
Brookland Park Plaza Apartments
Richmond, Virginia
FHA Project No. 051-36617

Dear Mr. Hamernick:

I am writing on behalf of Brookland Park Plaza Limited Partnership, a Maryland limited partnership (the "Partnership") and developer of Brookland Park Plaza in Richmond, Virginia, to request (i) a waiver of certain provisions contained in HUD Letter 88-14, July 21, 1988, entitled "Coinsured Project Mortgage Loan Transactions with Special Side Features" (the "Letter") and (ii) clarification of certain points in the Letter.

Brookland Park Plaza (the "Project") involves the conversion and substantial rehabilitation of an abandoned elementary school in Richmond, Virginia into a 77-unit apartment project for the elderly, 72 units of which will be subsidized under the Section 8 Moderate Rehabilitation Program and 5 units of which are intended to be subsidized under the Project Based Assistance Program. Not only will the Project provide much needed housing, but in addition, it will remove an eyesore from the neighborhood and will serve as the foundation for further economic and community development for the Highland Park neighborhood. I would also like to bring to your attention the fact that this is one of the few projects, if not the only project, of its size in the Richmond area with minority sponsorship.

Benton Mortgage Company will provide both construction and permanent financing under the 221 coinsurance loan program. Our commitment contemplates the making of a $2.9 million loan.

The Virginia Housing Development Authority ("VHDA") has issued a commitment to the Partnership to participate in this financing by purchasing the GNMA Project Loan Certificate (the "GNMA Certificate") to be issued by Benton Mortgage Company, with money from its General Fund (the "Fund") allocated to its Virginia Housing Fund. VHDA agreed to purchase the GNMA Certificate at a 6% interest rate, thereby making the Project feasible. Not only is the 6% interest a below market rate, it is also a rate below the tax exempt rate at which VHDA normally loans funds. VHDA has a policy to "recycle" money from the Fund within ten (10) years. As a further indication of its commitment to the Project, VHDA has extended the ten (10) year policy to fifteen (15) years because of the Project's intended use of Federal tax credits requiring an occupancy compliance period of fifteen (15) years.

VHDA will collect a discount from the Partnership at closing in an amount equal to the difference between the 6% return on the GNMA Certificate and an 8 1/2% return which has been determined by VHDA to be an acceptable rate of return for a 15 year period.

VHDA shall have the right to sell the GNMA Certificate at any time. However, commencing on the 1st day of the fifteenth year after the financing and continuing as long as the GNMA Certificate remains outstanding, VHDA is requiring that it be able to set a "sale" date for the GNMA Certificate (on which, if VHDA still holds and wishes to sell the GNMA Certificate, such Certificate shall be sold or, if VHDA does not then hold or does not wish to sell the GNMA, a "hypothetical sale" shall be held) and thereby determine the amount of principal loss, if any, that is or would be sustained by VHDA on such a real or hypothetical sale. Recognizing that the 6% yield is substantially below market and that VHDA is likely to sustain such a loss upon the aforementioned real or hypothetical sale of the GNMA Certificate, VHDA has also required the Partnership to reimburse it for this loss. In addition, commencing on the first day after the fifteenth year and continuing until this "sale" date (or until the GNMA Certificate is paid off), VHDA is requiring the Partnership to pay contingent interest at the rate of 2.50% per year to increase its yield on the GNMA Certificate to 8.5%. The Partnership's obligation to pay the contingent interest and to reimburse VHDA for any principal loss will be evidenced by a subordinate promissory note secured by a subordinate deed of trust.

The policies contained in the Letter impair VHDA's ability to realize on its security thereby jeopardizing VHDA's participation. Specifically, the 50% limitation on payment of surplus cash for contingent interest contained in Section III(B)(5) of the Letter and the 75% limitation on payment upon the occurrence of a "payment event" contained in Section III(B)(6) of the Letter severely impact on VHDA's ability to receive full repayment of its loan. Under these procedures VHDA will not participate in the financing of the Project.

It is our understanding that the 50% and 75% limitations contained in the Letter exist to ensure that principals are committed to stay with a project. We understand also that there is no limitation on what principals can do with their respective distributions of surplus cash. VHDA has been offered pledges of partnership interests, assignments of partnership interests and personal guaranties as alternative or supplemental security, but it is not willing to accept any other security other than a subordinated deed of trust or subordinated note.

Accordingly, we hereby request a waiver of the aforementioned limitations with respect to this financing as follows:

(1) With respect to Section III(B)(5) of the Letter, the words "50% of" in the second sentence shall be deleted and

(2) With respect to Section III(B)(6) of the Letter, only the first sentence thereof shall be applicable, and the remainder shall be deleted.

VHDA has also requested confirmation from you that the actual or hypothetical sale of the GNMA certificate is a "payment event" as contemplated by Section III (B)(6) of the letter. Specifically, VHDA would like to know that Section III (B)(6) does not impede its ability to sell the GNMA Certificate, either actually or hypothetically, declare a default under its subordinated note if the partnership fails to pay the amount of the principal loss and, foreclose on its subordinate deed of trust subject to our coinsured mortgage financing and transfer of physical assets approval. It is important to note that consistent with the requirements of the Letter, under no circumstances would a Partnership default under the VHDA documents constitute a default under Benton's coinsured mortgage loan documents with the Partnership.

Thank you for your consideration of this request. Please feel free to contact me at any time if you have questions or require any further information regarding this matter.

Sincerely,

BENTON MORTGAGE COMPANY

William Tanker

William Tanker
Vice President

WT/bjh

NOTE REGARDING ATTACHED LETTERS

While BMC was waiting for a response from HUD, the developer took the project to another coinsuring lender, whereupon it achieved Endorsement as a refinancing transaction.

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY FOR
HOUSING-FEDERAL HOUSING COMMISSIONER

SEP 20 1989

Mr. Thomas G. Ford
President
Benton Mortgage Company
P.O. Box 19803
Knoxville, TN 37939-2803

Dear Mr. Ford:

Thank you for your letter dated June 23, 1989, following the Department's June 6 meeting with the coinsurers, in which you illustrate one of the problem areas needing clarification.

Specifically, you indicate a need to clarify the distinction between a purchase and a refinance. The Department is cognizant of the interpretive confusion that exists among HUD and coinsurer staffs and is reviewing the definitions contained in HUD Handbook 4566.1 REV-1. Guidelines that are more clear to program participants will be issued in the near future.

Very truly yours,

for ~~F~~rank D. Brown
Deputy Director
Office of Insured Multifamily
Housing Development

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY FOR
HOUSING-FEDERAL HOUSING COMMISSIONER

JUN 12 1989

Mr. Thomas G. Ford
President
Benton Mortgage Company
P.O. Box 19803
5731 Lyons View Drive
Knoxville, TN 37939-2803

Dear Mr. Ford:

This is in response to your letter of February 13, 1989, inquiring whether a loan application presented to you under a given set of circumstances should be considered a purchase or refinance transaction under the Section 223(f) Coinsurance program.

The facts as presented in your letter indicate that the developer intends to purchase the subject real estate using interim financing to avoid expiration of an option agreement. Within one month of the purchase, the developer will pay off the interim debt with a Section 223(f) coinsured loan. The mere fact that closing the coinsured loan could not be completed prior to expiration of the developer's option agreement does not change the essential fact that the developer intends to obtain a Section 223(f) coinsured loan to complete the purchase transaction.

Accordingly, it is our determination that the application, as presented in your letter should be considered a purchase transaction.

Very truly yours,

James L. Hamernick
Director
Office of Insured Multifamily
Housing Development

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February 13, 1989

VIA FEDERAL EXPRESS

Mr. James L. Hamernick
Director
Office of Insured Multifamily
Housing Development
U. S. Department of Housing
and Urban Development
451 Seventh Street, S. W. - Room 6134
Washington, DC 20410

Re: Section 223(f) Coinsurance
Purchase vs. Refinance

Dear Mr. Hamernick:

A developer has sent us an application to do a 223(f) refinancing on a PBA project. We question whether or not the project should be classified as a 223(f) refinance or a 223(f) purchase.

According to Paragraph 9-4 of HUD Handbook 4566.1 REV-1, "A purchase transaction is one in which the property is changing hands by way of a sale on an arms length basis. A refinance transaction is one in which an existing owner is restructuring the mortgage debt against the property."

The following is a summary of the facts surrounding the case. The developer has an option on a property. He plans to purchase the property in two weeks. We are unable to process a loan to meet his timetable. Therefore, he must get a loan from a bank to purchase the property. Approximately one (1) month after he closes the loan with the bank he would like to restructure his debt by closing a 223(f) loan with processing based upon a refinancing transaction.

Is this a 223(f) refinancing transaction or a 223(f) purchase transaction?

Sincerely,

BENTON MORTGAGE COMPANY

Thomas G. Ford
President

TGF/bjh

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

DEC - 6 1988

Mr. David Queen
Chief Underwriter
Benton Mortgage Company
5731 Lyons View Drive

Dear Mr. Queen:

This replies to your letter of September 8, 1988, requesting clarification of instructions on Section 8 program processing in conjunction with Section 223(f) and 221(d) coinsurance programs. You cited interpretations from Coinsuring Letter No. 88-13 (88-13) and a memorandum dated January 4, 1988, from the Assistant Secretary for Housing. Both pieces of correspondence address rent comparability under coinsurance programs involving Section 8 rental assistance.

You are correct in that 88-13 specifically addresses proposals where HAP Contracts have been executed prior to an application for coinsurance and the January 4 memorandum addresses Section 8 Moderate Rehabilitation (Mod Rehab) proposals where a HAP Contract has not yet been executed but will be after completion of mortgage insurance processing. You should note, however, that these memorandums are not mutually exclusive. The Mod Rehab memorandum speaks only about the Mod Rehab program where new 15-year contracts are being created. Many of the rules contained in 88-13 are also in the Mod Rehab memorandum. The Mod Rehab memorandum only talks about the one program at the one point in time and, therefore, has a narrower set of rules. They are not inconsistent with the broader 88-13 on the specific cases discussed in the Mod Rehab memorandum.

The instances allowing the special adjustments to processing rents for projects with Section 8 assistance specified in 88-13 apply in rent comparability analyses to all areas of mortgage insurance processing outlined in both issuances with the exception of one processing circumstance covered in the January 4 memorandum. When processing a Mod Rehab proposal under Section 221(d), a special adjustment to the processing rents not to exceed 20 percent may be applied to rent comparability analyses in those circumstances where a new full term (15-year, unconditional, with full budget authority) contract is to be executed. This exception is not available where the full 15 years is not available and/or is conditioned on PHA approval of extensions or on funding availability.

In all other areas of mortgage insurance processing, whether it be the refinancing or purchase of Section 8 projects (with outstanding HAP Contracts) under Sections 223(f) or 221(d) or the coinsurance of projects with benefit of Section 8 Mod Rehab (HAP Contract to be executed) under Section 223(f), the special adjustment to the processing rents that can be applied in comparability analyses may be a percentage equal to 1 percent for each year remaining in the Contract, not to exceed 15 percent.

The references to rents that a PHA may include in a HAP Agreement and Contract stated in the January 4 memorandum remain in effect and are in accordance with the Mod Rehab instructions in HUD Handbook 7420.3 as clarified by the January 4 memorandum. As you indicated, this constraint does not apply under 88-13. The reason it does not apply to the 88-13 instructions is that the coinsurance of a project with an existing Section 8 Contract does not [illegible] in an existing Section 8 Contract. Any improvements made are not funded with additional Section 8.

Regardless of whether a project is insured under Section 223(f) or 221(d), if a HAP Contract has been executed in advance of a HUD coinsurance commitment, processing rents used to establish the mortgage amount will be the lesser of the Section 8 contract rents or rents by market comparability plus the applicable adjustment for projects with Section 8 assistance of 1 percent for each year remaining on the HAP Contract, not to exceed 15 percent.

We appreciate your efforts toward responsible underwriting in conjunction with our coinsurance programs and hope the foregoing clarifies the comparability issue for projects with Section 8 assistance.

Very sincerely yours,

R. Hunter Cushing
Deputy Assistant Secretary for
Multifamily Housing Programs

Benton Mortgage Company

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September 8, 1988

Mr. R. Hunter Cushing
Deputy Assistant Secretary
for Multifamily Housing Programs
U. S. Department of Housing
and Urban Development
451 Seventh Street, S. W.
Washington, DC 20410

Re: Applicability of Coinsuring Lender Letter 88-13 to Developments That Have Not Yet Received HAP Contracts

Dear Mr. Cushing:

I wish to thank you and Mr. Hamernick for your candid observations regarding the relationship between coinsurance and the Section 8 programs. In the course of the conversation, you conveyed an interpretation of Coinsuring Lender Letter 88-13 that differs from my earlier understanding.

Coinsuring Lender Letter 88-13 and the earlier Memorandum dated March 24, 1986 consistently refer to Section 8 HAP Contracts and rents currently in effect. Consequently, I inferred that these procedures do not apply to developments which currently are not subject to a Housing Assistance Payments Contract, but will become so after proper execution of a HAP Agreement and acceptable completion of the prescribed rehabilitation. In these instances, I believed that the applicable procedures are those set forth in the Assistant Secretary's letter dated January 4, 1988 concerning coinsuring Section 8 Moderate Rehabilitation projects. It appears from our conversation that this interpretation is incorrect.

The implications of Coinsuring Lender Letter 88-13 for processing Section 8 Moderate Rehabilitation, Property Disposition or other developments for which HAP Contracts are not yet executed are twofold:

1. The Memorandum dated January 4, 1988 allows a 20% adjustment of trended correlated subject rents for Moderate Rehabilitation projects coinsured under the Section 221(d)(4) program. Coinsuring Lender Letter 88-13 reduces this adjustment to 1% per remaining year of the HAP Contract, or 15% in most instances;

2. The Memorandum dated January 4, 1988 provides that rents based on market comparability constrain the rents which the Housing Authority may include in the Agreement to Enter into Housing Assistance Payments Contract. This constraint does not apply under Coinsuring Lender Letter 88-13, although market comparability continues to control the rents used in determining the maximum insurable mortgage amount.

Please clarify whether Coinsuring Lender Letter 88-13 is meant to supersede the January 4, 1988 Memorandum in this manner. I emphasize that I do not object to the interpretation which you have conveyed. Rather, I am seeking to confirm that I now have a proper understanding of your intent.

Benton Mortgage Company concurs that reasonable rents are an essential part of responsibly underwriting Section 8 Moderate Rehabilitation projects. We are attempting to educate our clients to conduct initial feasibility analyses for these developments using comparable market rents. In this manner, we hope to engender mortgage amounts that will best facilitate an orderly transition to market rate housing at the end of the HAP Contract term.

Sincerely,

BENTON MORTGAGE COMPANY

David E. Queen
Chief Underwriter

DEQ/bjh

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY FOR
HOUSING-FEDERAL HOUSING COMMISSIONER

APR 15 1988

Mr. David E. Queen
Chief Underwriter
Benton Mortgage Company
5731 Lyons View Drive
PO Box 19803
Knoxville, TN 37939-2803

Dear Mr. Queen:

This is in reply to Mr. Joe K. Hawkins' January 9 letter regarding permitted fees to loan correspondents with an identity of interest with prospective coinsurance mortgagors.

The mortgagee approval regulations at 24 CFR Section 203.1(b) prohibit the lender from paying "anything of value, directly or indirectly, in connection with any insured mortgage transaction or transactions to any person or entity if such person or entity has received any other compensation from the mortgagor, seller, builder or any other person for services related to such transactions or related to the purchase or sale of the mortgaged property, except that compensation as may be approved by the Commissioner may be paid for services actually performed." Referral fees are also prohibited in every case. For multifamily housing projects, we have generally held that fees such as you describe may be paid provided that:

1) The function would have had to be done in any event (in this case, by you as coinsuring lender); and

2) Services are actually rendered and payment is reasonable and customary.

In the coinsurance programs, we have additional concerns. First, the total fees charged to the mortgagor may not exceed the maximum fees permitted in the applicable coinsurance program. Second, the coinsuring lender and its approved staff must be completely responsible for all processing and underwriting. The correspondent may coordinate the application process between the mortgagor and Benton Mortgage to expedite matters and because of physical distance, but the correspondent may not actually assist in the analysis of cases in which it is involved. We also assume that these correspondents have no identity of interest with Benton Mortgage. Any such identity with the correspondent would in turn create an identity with the mortgagor and require HUD Headquarters review before issuance of any commitment.

We hope this addresses your concerns.

Very truly yours,

James L. Hamernick
Director
Office of Insured Multifamily
Housing Development

Benton Mortgage Company

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January 29, 1988

Mr. James L. Hamernick
Office of Insured Multifamily
Housing Development
United States Department of Housing
and Urban Development
451 Seventh Street, S. W., Room 6134
Washington, DC 20410-5500

Re: Payment of Correspondent's Fees

Dear Mr. Hamernick:

Benton Mortgage Company, as coinsurer in both the 223(f) and 221(d)(4) programs, is receiving numerous loan applications submitted to us for processing by various loan correspondents. In some of the cases correspondents have an identity of interest with sponsors/mortgagors. The following are more detailed examples of the various fact situations which we encounter. In none of these cases does Benton Mortgage Company have any ownership interest in the project.

In all cases the correspondent is paid only for work actually performed on the particular case on which he is paid. The fees will not be higher than the ordinary and customary fees paid to correspondents in the industry and will not exceed the fees which would be paid to a non-identity of interest correspondent. In addition to our working with the correspondent in determining that he has earned his fee, we are going to require the correspondent to execute the attached certificate prior to any payment to him by us.

Scenario #1

Some of the partners of the mortgagor entity are also owners of the correspondent company that routinely packages and submits loan applications to various lenders.

Scenario #2

The owners of the correspondent entity lease office space from a sponsor or partner of the mortgagor. The mortgagor's partners own none of the correspondent entity and the owners of the correspondent entity own no interest in the mortgagor.

Scenario #3

A correspondent who has been paid a correspondent's fee on various financings on which he has no identity of interest subsequently buys a project and wants us to finance it.

Scenario #4

A partner or owner in a project that has been endorsed is also an owner of a firm that is acting as loan correspondent on a subsequent project in which the partner has no ownership interest. The correspondent would receive a fee for services rendered.

Since, in all these cases, the fees so paid are for services actually rendered, we believe that there is no violation of the kickback or rebate provisions applicable to insured multifamily transactions. We believe this is true whether or not the correspondent has an ownership interest in the specific project.

I look forward to your reply on these situations so that we may continue our processing of cases submitted by various loan correspondents. I appreciate your consideration of these issues and a written response from you as to the Department's position. If you have any questions, please contact Tom Ford or me.

Sincerely,

BENTON MORTGAGE COMPANY

Joe K. Hawkins
Executive Vice President

JKH/bjh

Enclosure

CERTIFICATE AND RECEIPT

Project Name:_________________________
FHA Project No:_________________________

______________________________________ hereby acknowledges the receipt from Benton Mortgage Company of a fee in the amount of $_________________. This fee represents compensation for services rendered in packaging the loan application and in assisting the coordination of the loan processing between the mortgagor and Benton Mortgage Company. We hereby certify that the receipt of this payment does not violate the anti-kickback rules of the Department of Housing and Urban Development. No part of this fee is being paid to the mortgagor or to any other person who has received any other payment for services related to the insured mortgage transaction.

____
(Correspondent)

F

NOTE REGARDING ATTACHED LETTERS

As a result of the delays caused by HUD's non-response, this project has not achieved Final Endorsement, and BMC has had to pay $121,950.00 in GNMA extension fees.

Benton Mortgage Company

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March 25, 1989

Mr. James L. Hamernick
Acting Deputy Assistant Secretary
for Multifamily Programs
U. S. Department of Housing
and Urban Development
451 Seventh Street, S. W. - Room 6134
Washington, DC 20410

Re: Pebble Creek Apartments
Arlington, Texas
FHA Project #113-36607

Dear Mr Hamernick:

In accordance with your letter dated March 23, 1989, I have enclosed the Mortgagor's and General Contractor's Certificates of Actual Cost along with Benton Mortgage Company's reviews and determination of maximum insurable mortgage. I have also enclosed all change orders submitted with respect to the project. I respectfully request that you complete your analysis of these documents as quickly as possible since Final Endorsement is scheduled to occur on Wednesday, March 29, 1989. Although we shall not proceed to Endorsement without your approval, we wish to accommodate our client's need and desire to close.

Thank you for your prompt attention in this matter. I hope that you concur with our determinations. Please advise me of any comments or questions that you may have at your earliest opportunity.

Sincerely,

BENTON MORTGAGE COMPANY

David E. Queen
Chief Underwriter

cc: J. Muss
A. Hessel

Enclosures

NOTE REGARDING ATTACHED LETTERS

As a result of the delays caused by HUD's non-response, BMC had to pay $17,017.19 in GNMA extension fees and penalties.

Benton Mortgage Company

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June 23, 1989

Mr. James L. Hamernick
Acting Deputy Assistant Secretary
for Multifamily Programs
U. S. Department of Housing
and Urban Development
451 Seventh Street, S. W. - Room 6134
Washington, DC 20410

Re: West Dade, Ltd.
Miami, Florida
FHA Project #066-36632

Dear Mr. Hamernick:

In accordance with your letter dated March 23, 1989, I have enclosed the Mortgagor's and General Contractor's Certificates of Actual Cost, along with Benton Mortgage Company's reviews and determination of maximum insurable mortgage. I previously transmitted all approved Requests for Construction Changes by letter dated April 14, 1989. I have not furnished the approved change orders to the HUD Field Office, but I shall do so at your request.

As a result of substantial cost savings during construction, the final insurable mortgage is over $300,000 less than the amount approved at initial endorsement. In addition, the housing authority and Benton have approved a conversion of certain efficiency apartments to one bedroom units, thereby increasing monthly gross income. The lower mortgage amount and higher income alleviate the concern that some have expressed regarding expenses at this project.

I respectfully request that you complete your analysis of these documents as quickly as possible. The sponsor is incurring extension fees on the GNMA securities each month and contends that Benton Mortgage Company is liable for these costs. The owners of the two other developments that you have impeded from proceeding to Final Endorsement have made similar representations and have explicitly threatened to sue Benton Mortgage Company for damages.

Thank you for your prompt attention in this matter. Please advise me of any comments or questions that you may have.

Sincerely,

BENTON MORTGAGE COMPANY

David E. Queen
Chief Underwriter

DEQ/bjh
Enclosure
cc: Art Martinez

NOTE REGARDING ATTACHED LETTERS

BMC attempted to continuously improve its procedures and operations in accordance with HUD's guidelines. Coinsuring Lender Letter 87-20 required HUD to follow-up and resolve findings from formal evaluations. HUD violated their own procedures by their non-response, and made our own improvement efforts extraordinarily difficult.

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November 9, 1988

Mr. R. Hunter Cushing
Deputy Assistant Secretary
for Multifamily Housing Programs
U. S. Department of Housing
and Urban Development
451 Seventh Street, S. W.
Washington, DC 20410

Re: Monitoring Team Review Comments

Dear Mr. Cushing:

As you so appropriately indicated, coinsurance is a partnership between the Department and approved private sector lenders such as Benton Mortgage Company. We acknowledge that we are the junior partner in this relationship. Consequently, we must not only take heed of your concerns, but also continually benefit from the broader depth of knowledge which the Department possesses regarding mortgage insurance and coinsurance.

I wish to thank the staff of the Technical Support Branch for the instruction which they provided during the monitoring visit and continue to provide. My colleagues and I also wish to express our appreciation for the support that you and Mr. Hamernick have given the coinsurance programs and for the perspectives which you conveyed in our recent meeting. These observations have helped to sharpen the focus of our business objectives. We continue in our resolve to underwrite developments with reasonable rents, expenses and mortgage amounts for experienced, responsible owners with strong and stable financial profiles.

I wish to begin our response to the monitoring review findings with general comments. We are pleased by your characterization of Benton as a knowledgeable and sophisticated lender. However, just as you have struggled to improve your Coinsurance Division, we recognize the need to continue to improve our technical processing functions. In only two years, we have grown from an organization which had a handfull of technical staff to one which employs a total of some 50 persons. Controlling this growth and cultivating the skills and experience of the staff is not an easy task, as you can well appreciate.

In addition, we are confronted with the business pressures of competing with lenders who perhaps do not share our discipline or our resolve to uphold the Department's policies and procedures. This problem is unique to coinsurance among HUD's programs and makes quality control in all aspects of the lending process an even greater priority. We applaud your efforts to improve the monitoring of coinsuring lenders, and we hope that you will continue to support our efforts to improve.

I believe that we have accomplished significant positive strides in redefining our organizational structure and strengthening our technical capabilities since the monitoring review team visited one year ago. I wish to emphasize two major changes in our structure and capabilities that have been particularly beneficial.

First, Benton Mortgage Company has integrated the origination, underwriting and closing functions by introducing the "team concept". In the first 18 months of our history, we learned that understanding the capabilities of our clients shares equal priority with understanding the proposed real estate. We also learned that efficiency and prudence in underwriting begin with establishing a relationship of mutual respect with our clients, grounded in a common understanding of the client's objectives and HUD's program requirements. Finally, we learned that the best means of assuring the fulfillment of all requirements is to have one person who is involved in all aspects of a development from the time that we accept the application until the loan is closed. Your monitoring review comments were particularly helpful in underscoring the importance of this last lesson.

Our original structure of independently functioning origination, production and closing divisions engendered neither the depth of client relationship nor the continuity of staff participation that we now regard as being essential. The team concept rectifies this shortcoming by pairing a maximum of three originators with an underwriter and an assistant underwriter who are responsible for coordinating the processing and closing of the loans. This ongoing linkage between originators and underwriters maximizes the underwriters' ability to develop a close, consistent relationship with our clients.

The underwriter's ubiquitous role in processing assures proper evaluation and implementation of the loan. The underwriter interprets architectural and cost reviews, analyzes appraisals and performs the mortgage credit and management reviews, including on-site conferences with the client and the managing agent. All of these activities are, of course, carried out under the supervision of the Chief Architect and Chief Cost Analyst, the Chief of Management and Mortgage Credit and the Chief Underwriter. This comprehensive involvement enables the underwriter to present the Loan Committee with the best possible information and recommendations based on full knowledge of all elements of the proposed financing. Following approval, the underwriter controls the sale of mortgage-backed securities and the closing of the loan, fully cognizant of the essential prerequisites for consummating the transaction.

The second major change concerns the architectural and cost review functions. The monitoring team was justly critical of our performance in this area. Your comments spurred us to address our deficiencies thoroughly and with due haste. At the time of the monitoring visit, we routinely employed outside technical consultants to perform architectural and cost analyses. The illness of our Chief Architect/Chief Cost Analyst coupled with the inexperience and incompetence of the in house staff that we initially hired resulted in a deficient level of quality control.

Since February of this year, we have recruited two new professionals to our architectural and cost section who are committed to improving our review capabilities. I am very pleased to report that Mr. Charles Griffin and Mr. Curtis Rolen have shown a great deal of initiative and success in progressing towards our goal of developing reliable, fully documented architectural and cost review systems.

Our staff now perform architectural and cost analyses for virtually all Section 221(d)(4) developments. We have also internalized the review of Section 223(f) developments involving significant amounts of repairs. I believe that our staff is currently providing a much more thorough and thoughtful review of the contract documents, the scope of work and the associated costs than our consultants previously conveyed. I am also confident that this approach provides the continuity necessary to assure that all architectural comments are satisfactorily resolved prior to closing.

The advent of our computerized Benchmark Cost System will significantly improve the cost review function. Mindful of your concern, my staff and I are working with deliberate speed to assure that the basic system will be fully functional by the end of this year. We intend to continue to expand the system to track the effect of change orders and create a data base of certified costs.

A final point that I wish to emphasize is one which we discussed in our recent meeting. As you have noted, a significant portion of our portfolio consists of Section 8 assisted developments. We agree that responsible underwriting is particularly vital with respect to these projects. As we have matured in our thinking and experience, we have redoubled our resolve to continue to minimize coinsurance risk at the end of the HAP Contract period and promote the cost effective use of Section 8 housing assistance. As was apparent from the example that I gave at our meeting, we are sincerely attempting to reconcile these program demands with our concern for the quality of our mortgage security and our clients' insistence on favorable loan to cost ratios. I admit that we have not yet achieved a 100% success rate in implementing these objectives. However, I assure you that we hold the perspective which you require. I hope that other coinsuring lenders who finance Section 8 assisted developments are as attuned and sensitive to your concerns as we are.

I wish to again thank you and your staff for your comments and recommendations. The attached Addendum contains a point by point response. I hope that our explanations, justifications and capitulations are satisfactory. In the event that any response fails to adequately address your concern, please notify me immediately.

Sincerely,

BENTON MORTGAGE COMPANY

David E. Queen
Chief Underwriter

DEQ/bjh
Enclosures

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY FOR
HOUSING-FEDERAL HOUSING COMMISSIONER

DEC 3 1987

Letter No. 87-20

TO ALL COINSURING LENDERS

SUBJECT: Liaison Responsibilities - Coinsurance Division

As the coinsurance programs have grown, so has the need to improve coordination and communications between coinsuring lenders and HUD. To help meet this need, staff in the Coinsurance Division will be assigned liaison responsibilities for selected activities involving individual coinsuring lenders. Although these liaison responsibilities will change over time, initially they will include the following:

1. Requests from Lenders

The liaison person will be responsible for following up various lender requests in central office, such as: (a) requests for information, (b) policy exceptions, (c) waivers, and (d) appeals, etc. The intent is to make sure the lender's request is receiving timely consideration from HUD, not for the liaison person to assume responsibility for the substance of the reply.

2. Clearing Formal Evaluations

Experience has shown the need for continuous follow-up to satisfactorily resolve the various findings and recommendations that result from formal evaluations of lender activities. The liaison person will be responsible for making sure that the formal evaluations are properly closed out and that key HUD findings and recommendations are adopted.

3. Remote Monitoring

The liaison person will be responsible for monitoring monthly lender activity under the Coinsurance Analysis System (CAS). The liaison person will review with the lender those projects that trigger various threshold criteria for HUD review and when appropriate, provide the lender with written comments based on these reviews.

4. Periodic On-Site Visits

These visits will serve several purposes, such as reviewing progress in implementing recommendations resulting from formal evaluations; conducting on-site reviews of projects; discussing program changes and lender recommendations for improving HUD's management of the coinsurance programs.

In the next few days you will receive notification of the liaison person assigned to work with you. I know you will make every effort to make our liaison effort successful.

Very truly yours,

James L. Hamernick

James L. Hamernick
Director
Office of Insured Multifamily
Housing Development

NOTE REGARDING ATTACHED LETTERS

As noted in both the hearing and in our response, considerable confusion exists regarding the interface between the Moderate Rehabilitation and Coinsurance Programs. This letter address a central point in the rent issue; however, BMC never received a response to our question.

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February 27, 1989

VIA FEDERAL EXPRESS

Mr. James L. Hamernick
Director
Office of Insured Multifamily
Housing Development
U. S. Department of Housing
and Urban Development
451 Seventh Street, S. W. - Room 6134
Washington, DC 20410

Dear Mr. Hamernick:

I am writing to request a clarification of a letter dated December 31, 1987, from Assistant Secretary Thomas T. Demery to All Coinsuring Lenders (and others). The subject of this letter was "Processing of Section 221(d) and 223(f) Coinsurance Projects With Section 8 Moderate Rehabilitation".

My specific question deals with the paragraph entitled "New PHA Authority". In this paragraph, Mr. Demery states in part, ..."the rents included in the Section 8 Agreement and HAP Contract for coinsured Moderate Rehabilitation projects will be the lesser of the comparable rent determined by the Coinsurer or the rent calculated by the PHA." Does this sentence mean that the PHA must compare the initial base and contract rents they have computed under 24 CFR 882, and Handbook 7420.3, REV-2, Appendix 31 with the market comparability data compiled by a coinsuring lender prior to their determination of what rents they will include in the Section 8 HAP Contract? Or, does this sentence really intend to duplicate the language in the paragraph entitled "Continued Coinsurer Responsibility", wherein the coinsuring lender is instructed to use the lesser of the PHA cost-determined rent or the coinsurer compiled market comparable rent?

We are currently processing several cases contemplating the use of Moderate Rehabilitation Section 8 rental assistance, therefore, your interpretation of this letter will be most helpful. I request that you respond in writing with your Department's position on this point at your earliest convenience.

Thank you for your cooperation.

Sincerely,

BENTON MORTGAGE COMPANY

William Tanker

William Tanker
Vice President

WT/bjh

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April 27, 1989

Mr. James L. Hamernick
Acting Deputy Assistant Secretary
for Multifamily Programs
U. S. Department of Housing
and Urban Development
451 Seventh Street, S. W. - Room 6134
Washington, DC 20410

Re: Kingsley Park Apartments
Essex, Maryland
FHA Project #052-36611

Dear Mr. Hamernick:

In accordance with your letter dated March 23, 1989, I have enclosed the Mortgagor's and General Contractor's Certificates of Actual Cost along with Benton Mortgage Company's reviews and determination of maximum insurable mortgage. I have also enclosed all change orders submitted with respect to the project.

I respectfully request that you complete your analysis of these documents as quickly as possible. We had originally planned to Finally Endorse this development during the last week of March. The owners indicate that they intend to seek damages from Benton Mortgage Company if the unanticipated delay precipitated by your request results in significant additional costs.

Thank you for your prompt attention in this matter. I hope that you concur with our determinations. Please advise me of any comments or questions that you may have at your earliest convenience.

Sincerely,

BENTON MORTGAGE COMPANY

David E. Queen
Chief Underwriter

DEQ/bjh

Enclosures

COINSURANCE

TUESDAY, MARCH 27, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
HUD/MOD REHAB INVESTIGATION SUBCOMMITTEE,
Washington, DC.

The subcommittee met at 9 a.m., in room SD-538, Dirksen Senate Office Building, Senator Bob Graham (chairman of the subcommittee) presiding.

Present: Senators Graham and Mack.

OPENING STATEMENT OF SENATOR GRAHAM

Senator **GRAHAM**. Good morning. Today the Subcommittee will be reviewing the Department of Housing and Urban Development's coinsurance programs and the Government National Mortgage Association's related mortgage-backed securities program.

Last September, the full Banking Committee heard testimony regarding certain abuses that occurred when the Federal credit enhancement of mortgage coinsurance was combined with section 8 Mod Rehab rent subsidies as well as low income Federal tax credits. The abuses included overmortgaging by the coinsuring lender and the lender's exercise of HUD's discretion in setting section 8 rent levels that resulted in excessive rent subsidies. The committee's witnesses included HUD, the HUD inspector general, and the Mortgage Bankers Association.

Since last September, HUD has completed its evaluation of the coinsurance programs and received a final report from its consultant, Price Waterhouse, which was retained to assist in HUD's evaluation. Also, HUD has conducted discussions with coinsurer representatives regarding certain proposed changes in the coinsurance programs. These were unsuccessful in identifying mutually acceptable terms, and in January of this year HUD Secretary Kemp announced his decision to terminate the coinsurance programs. Some coinsurers initiated litigation in response to this announcement and related decisions of HUD regarding program procedures.

In proceeding with today's agenda, the subcommittee does not mean to substitute itself for the Federal court that has jurisdiction over this pending litigation. I want to emphasize that the focus of this hearing is not whether Secretary Kemp's January determinations were correct procedurally or on the merits; the focus is HUD's prior actions and inactions.

The Congress in recent years has experienced an unfortunate and very costly reluctance on the part of certain agencies within the executive branch to be forthcoming regarding administrative failures and their resulting costs. I, for one, was particularly concerned and upset with the failure of the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation to come forward and provide the Congress with a reasonable estimate of the cost of the thrift debacle.

Secretary Kemp has been very assertive in the attempted resolution of this debacle through his active participation in the deliberations of the Resolution Trust Corporation's oversight board and the Federal Housing Finance Board's directorate. I appreciate the role assumed by the Secretary and expect the public to benefit by it. I also appreciate HUD's willingness to participate in this roundtable discussion format and look forward to a full and frank airing of the issues.

Earlier in March, Senator Mack and I conducted in Tampa, FL, a roundtable discussion of current housing issues with various interested public officials and private citizens. We found the format worked very well, particularly in developing a consensus on actions required to address problems and in identifying areas of disagreement as well.

Today, the subcommittee intends to address four basic questions.

First, how was the coinsurance authority implemented prior to May 1983 when the Reagan administration launched its section 223(f) coinsurance program?

Second, what were the flaws in the design and conception of the post-May 1983 coinsurance programs under section 223(f), 221(d) and 232, and the related Ginnie Mae mortgage-backed securities program?

Third, what were the failures in the implementation of the post-May 1983 coinsurance programs and the related Ginnie Mae mortgage-backed securities program?

Fourth, what losses have been and are likely to be realized by Ginnie Mae and HUD in the coinsurance programs and the related mortgage-backed securities program, and what actions are Ginnie Mae and HUD taking—and can they take—to mitigate those losses?

We want to discuss each of these questions fully. We, therefore, intend to impose time limits that will facilitate this. Each of you has received a copy of today's agenda that shows these limits. We have received your written testimony and a copy will be placed in the record. In the interest of time, however, we will proceed immediately to a discussion of the issues on the agenda.

In proceeding today we, unfortunately, must take account of the Senate's agenda. At approximately 9:30, Senator Mack and I will have to recess the hearing in order to go to the floor to vote on an amendment to the pending clean air legislation. I apologize for this interruption and hope that prior to that interruption that we can complete the discussion on question number one.

Senator Mack.

Senator **Mack**. Thank you, Senator Graham.

I do have a prepared statement which I will submit for the record and maybe make just a few comments.

OPENING REMARKS OF SENATOR MACK

Senator Mack. I want to welcome today's witnesses and commend representatives from HUD for their swiftness in addressing the problems associated with multifamily coinsurance.

The coinsurance program allowed private lenders to unilaterally commit the Federal Government to insuring 80 percent of loan value, but poor program design often led to the Federal Government taking on 100 percent of the risk. Irresponsible coinsurers took advantage of poor program design by inflating mortgage amounts which could not be paid for through project income.

I am hopeful that as we go through our discussions this morning that we will be able to identify the problems in that program design that created this problem so that we can hopefully eliminate programs that fall into this same category. And I would just say one common thread that I see through many of the problem we are dealing with—and, Bob, you referred to our dealing with the S&L issue—one of the things that we seem to have failed to understand, that as Government allows for an expansion of scope of involvement, whether that was in the S&L industry or whether that's in coinsurance, we failed to seem to understand the significance of these huge pots of money that drew people in to being involved into the process and at the same time failed to put in place the supervisory mechanism, the internal control systems that were necessary to keep track of in fact what was going on. That's a common threat that I think we find both in the S&L problem and also in the coinsurance problem.

So again, I welcome all of you. I appreciate your willingness to participate and I think this should be a very helpful process this morning.

[The complete prepared statement of Senator Mack follows:]

CONNIE MACK
FLORIDA

Connie Mack

United States Senate
WASHINGTON, DC 20510

SENATOR CONNIE MACK
OPENING STATEMENT
HUD/MOD REHAB INVESTIGATION SUBCOMMITTEE HEARING ON FHA'S CO-INSURANCE PROGRAMS
March 27, 1990

I would like to welcome today's witnesses and commend representatives from the Department of Housing and Urban Development (HUD) for their swiftness in addressing the problems associated with the Multifamily Coinsurance program during their brief tenure at HUD.

Multifamily Coinsurance was intended to provide mortgage insurance for the purchase or refinancing of existing multifamily housing and to provide mortgage insurance for the new construction or substantial rehabilitation of multi-family housing, under programs known as Section 223(f) and Section 221(d), respectively. The coinsurance program allowed private lenders to unilaterally commit the federal government to insuring about 80% of loans for these purposes.

In exchange for the authority to perform all the necessary underwriting, servicing, management and property disposition functions, approved lenders, under Section 223(f) and Section 221(d), would assume responsibility for a portion of any insurance loss on the coinsured mortgage. Poor program design, however, often led to the federal government taking on 100% of the risk.

Irresponsible coinsurers took advantage of poor program design by inflating mortgage amounts which could not be paid for through project income. I understand there was a single project in Houston which accounted for $38.3 million in losses to the federal government when a developer was able to obtain an inflated mortgage. Since lender fees were based on a percentage of mortgage amount, there was strong incentive for coinsurers to make excessive loans.

According the Government Accounting Office (GAO), losses from defaults in the coinsurance program are approximately $960 million for fiscal year 1988. The December 1988 HUD Inspector

General audit also found numerous systemic problems with the program.

On January 17, 1990, Secretary Jack Kemp announced that the coinsurance method of insuring multifamily housing is fundamentally unsound. I agree with him. Poor underwriting and over-mortgaging led to an excessive level of defaults. I support the Secretary's decision to stop distributing mortgage insurance through coinsurance and initiate plans to restructure HUD's Multifamily Coinsurance program.

When my good friend Bob Graham and I were asked to lead this HUD Investigative Subcommittee, we agreed that many of the problems at HUD are symptomatic of structural flaws in many of our housing programs. Multifamily coinsurance is a prime example of a program whose structure invited abuse. It was designed with virtually no risk to the government's coinsurer and predictably caused millions of dollars in losses to the federal government.

I hope we can learn from this experience and stop funding housing programs which are so structurally flawed. We need to get housing dollars to the needy, not to middlemen. I look forward to hearing from today's witnesses and hope we can come to a consensus on the obvious flawed policies that led to these problems.

Senator **Graham**. Thank you, Senator Mack.

As indicated, we are going to start with question number one in hopes of completing the discussion on that prior to the break at 9:30 for the first vote.

That question is: How was the coinsurance authority implemented prior to May 1983, prior to the administration's launching of its section 223(f) coinsurance program?

Mr. Hipps, in your prepared statement you discuss some of that pre-1983 history. I wonder if you would be willing to start the discussion with your comments on that.

GEORGE HIPPS, SENIOR VICE PRESIDENT, PW FUNDING, INC., WASHINGTON, DC

Mr. **Hipps**. Certainly, Senator.

As I indicated in my prepared remarks, coinsurance really had its first iteration in the single family program and there were extensive discussions with the mortgage banking industry and HUD at the time that was developed following the legislation in the middle 1970's, which resulted in the implementation of a single family mortgage insurance program of coinsurance, which has never been really used by the industry and which the industry really, I think it's fair to say, never saw much of a need for.

Ultimately, the single family delegated processing system that's currently in place made coinsurance sort of a moot issue.

There were then extensive negotiations between HUD and the representatives of the State housing finance agencies with the aim of implementing a program designed to provide delegated processing by State housing finance agencies with the HFA's taking a coinsured risk.

Those negotiations were prolonged and very detailed down to the technical level. The State agencies literally participated with HUD staff in the development of the regulations.

Again, that program, for reasons that the State agencies could better address than I, was never really used by them even though the regulations were put into place.

From the State agency interest, the Department turned towards extending coinsurance to private lenders because it was continuing to face deterioration in the quality of its staff through retirement and the inability to replace those people because of budget restrictions and I guess a long-term outlook by the officials of the Department at that time that those conditions were not likely to significantly improve in the near term. I think coinsurance became the logical choice in terms of trying to find an alternative vehicle other than in-house HUD processing for providing multifamily finance.

Section 223(f) was then selected as the initial effort in that area because of the belief that since it involved basically the sale or refinancing of existing structures it was far less complicated in terms of administration, both to develop regulations and for mortgage bankers to administer than were the other programs involving substantial rehabilitation or new construction where you had to deal with construction financing.

That's what led to the decision to move toward section 223(f) and of course those regulations were implemented and the program commenced I think in 1980—somewhere around there.

Senator GRAHAM. In the original July 1980 version of the section 223(f) program, I believe it was going to be restricted to depository institutions' participation. Is that correct?

If so, what was the rationale for that limitation and why was that limitation lifted?

Mr. HIPPS. I frankly, Senator, don't recall that as being the aim. My recollection is of some negotiations with the mortgage banking industry. There certainly was a lot of conversation about involvement of depository institutions and a hope I think did exist that there would be a more significant participation.

I think that there are a number of insured depository institutions that did participate in the coinsurance program, not directly, but through wholly owned subsidiaries who are mortgage companies. Chemical Bank had Chemical Mortgage Co., Bankers Trust has Bankers Mortgage. At one time Security Pacific had a subsidiary that participated as a coinsurer. So through that device, there were some depository institutions.

I can only presume that the requirements of coinsurance ultimately and the staffing that is required of a coinsurer, particularly in the new construction phases, raised serious questions for most depository institutions as to whether or not it was economical to enter into such a program which they basically didn't have the experience in. I think we have to keep in mind that most of the FHA business in the past has been provided by mortgage bankers, not by depository institutions. And with a lack of manpower of the type that the HUD rules ultimately required and the cost of obtaining that kind of talent, I think they had a business decision that I presume many of them made and decided it wasn't worth the effort to become involved in.

Senator GRAHAM. Any other comments on the pre-May 1983 circumstances which led to the adoption of section 223(f) coinsurance?

Senator MACK. Well, I have a question that I want to raise and maybe this is not the appropriate time to raise it, but because at some point we are going to get into a discussion of what the problems were or are, and it might be helpful to me anyway just to have a couple of comments, if there are those on the witness list that have some experience, as to where you see some failures in the process in the development of the idea or the design that led us up to 1983.

GAYE G. BEASLEY, MEMBER, BOARD OF GOVERNORS, MORTGAGE BANKERS ASSOCIATION, WASHINGTON, DC

Ms. BEASLEY. First of all, the reason that coinsurance came into being was that the field offices were not functioning very well at that point. It was becoming a very slow process to get loans fully insured by HUD.

Senator MACK. What time frame are we talking about here?

Ms. BEASLEY. The early 1980's. But coinsurance was a program that was piggybacked onto some already existing housing insurance programs like sections 223(f) and 221(d)(4). Both of those programs were based—the mortgage amount was based on cost rather than value.

I think that that was a fundamental flaw right from the beginning. But we were dealing with already existing FHA mortgage insurance programs that had been in place for years. But in hindsight, I think if the program had been based on value rather than cost, it would have been a lot more sound and I know Fannie Mae took a page out of that book and based their delegated underwriting program on value instead of cost.

Senator MACK. Let me just make sure that I understand what you're saying, that the coinsurance program was added, if you will, layered on top of another program that was already in existence and since that program which was in existence based its commitment on cost as opposed to value the new coinsurance program just kind of picked up on that theory and moved forward with it. Is that right?

Ms. BEASLEY. That's correct. There are three tests for mortgage amounts under sections 223(f) and 221(d)(4). One is statutory limits and the other is the net operating income and what the amount of debt service can be supported by that net income; and the third is the cost approach.

That was put in place because, I think, of congressional concerns that developers not be able to pull money out of these developments up front. A valid concern, but in hindsight, if financings—particularly refinancings—had been based on property value, appraised value, I think the overall program would have been much sounder.

Senator MACK. I guess what I'm trying to find out—so that some point in the future, whether that's a year from now or 5 years from now or 10 years from now we're going through maybe not just this program but others, where should that flag have been raised to say, wait a minute, we've got a problem there; you shouldn't be going on value; you shouldn't be going on income; you ought to be going on cost. Where should that have been picked up in this system as we moved—maybe I don't understand our system well enough here, but I'm willing to raise it.

Was it at HUD and the folks at HUD that put together a rule? Was it when the Congress put the coinsurance on the books in 1974 kind of a pilot program or a demonstration project?

Mr. HIPPS. That's correct.

Senator MACK. What I'm trying to do is find out whether those of us on the Banking Committee should have been more observant as this developed or whether it should have been at HUD or was it Congress in general or where should that have been picked up?

Ms. BEASLEY. I think those kinds of problems would have to have been picked up by HUD if at all because it's a fairly technical issue and I doubt that the members of Congress would be able to investigate the program to that extent.

But in 1983, they had a reasonably successful history with those fully insured insurance programs. So at that point, they were not concerned about an excessive amount of defaults and therefore didn't go back and reevaluate the entire system for computing mortgage amounts.

Senator MACK. OK.

Mr. HIPPS. I think I would add, Senator, just a little different perspective in answer to your initial question of what things maybe did HUD not take a close enough look at at the time.

I think that the atmosphere at HUD at the time coinsurance was being developed was primarily the effort to get the program in place and get the workload off HUD's back.

In that context, my memory says that most of the development of the program was aimed at the origination of the product and the actions of the lender in disposing of the product if there was a failure, eliminating the handling of the real estate by the Government and eliminating a lot of the Government involvement in the claims process.

I think that's where, in hindsight, HUD could have done a better job of paying more attention to what I would characterize as the management side of a loan rather than the origination side. The development of the regulations for the origination side went forward without the management procedures and management regulations really being clearly thought out at the same time, and items such as the claims payment process and things of that nature I don't think got the same height of attention that maybe it should have and some of those items might have resulted in a different answer had there been more attention paid to them at that time.

Senator GRAHAM. Mr. Dale.

LARRY DALE, SENIOR VICE PRESIDENT, MULTIFAMILY FINANCE AND HOUSING INITIATIVES, FEDERAL NATIONAL MORTGAGE ASSOCIATION, WASHINGTON, DC

Mr. DALE. Picking up on what George said, I would like to add a slightly different perspective. I think the focus was on the loan itself and on the risk-sharing arrangement pertaining to each individual loan. The FHA regulations go into great detail regarding the underwriting of a loan and the management of a loan. There was very little focus in the regulations upon the management of the relationship with the coinsuring lenders and the management of the overall coinsuring lenders' portfolio of coinsurance loans. You have a couple charts back here that are illustrative of the fact that one or two lenders got into the business early; and, because of that they entered into huge numbers of coinsurance contracts, giving HUD a very high concentration of risk in two or three lenders. The viability of these two or three lenders became essential to the integrity of the coinsurance program, as opposed to embarking on the program in a way that the risk amongst lenders was diversified and that the overall risk of the coinsurance loan portfolio, not each and every loan but the portfolio itself, was well-diversified.

In addition, the relationship between HUD and the coinsuring lender and the ability of the lender to make good on their part of the coinsurance bargain was never really questioned or addressed in the program regulations. It was assumed that coinsuring lenders would uphold their end of the risk sharing agreement. Now the big defaults and some of the major losses are because the lenders are not making good on their part of the bargain. The current situation was not even addressed in any serious way in the regulations.

In hindsight these issues should have been addressed at the outset of the coinsurance program.

Senator GRAHAM. At what point was it decided to take the step of securitizing these coinsured loans and by bringing Ginnie Mae into it effectively take the coinsurer out from any continued ownership of the loans?

Mr. HIPPS. I don't think, Senator, that that's the way it occurred. I don't think there was any decision that we're going to securitize these loans. I think what happened in that respect was nothing more than a recognition that that's the way the industry with respect to FHA mortgages primarily provided the financing. It was well known within the Department that the predominant amount of FHA multifamily mortgages that were being created were being created with the use of Ginnie Mae mortgage-backed securities. So it was recognition of a reality of the marketplace.

There were, as I think Mr. Lasko will probably recite better than I can, numerous discussions between Ginnie Mae and housing staff over the involvement of Ginnie Mae in the coinsurance program.

WARREN LASKO, EXECUTIVE VICE PRESIDENT, MORTGAGE BANKERS ASSOCIATION, WASHINGTON, DC

Mr. LASKO. I will address that, Senator.

I was at Ginnie Mae in those years and I think there was a presumption or an assumption that for the FHA insured loans to be funded, to find an outlet in the marketplace, they were going to have to serve as backing for Ginnie Mae securities.

At Ginnie Mae, we viewed our role as guaranteeing securities, guaranteeing the performance of a lender, not in terms of underwriting a mortgage but in terms of collecting mortgage payments and paying security holders.

We were rather firm at Ginnie Mae in saying in the event an issuer of securities failed, we didn't think it was our role to carry a coinsured loan, for us to become in effect the coinsuring mortgagee. That was back during 1981 or early part of 1982 as I recall.

In our dealings with others at HUD, we discussed through a situation which ultimately came to pass where in the event a loan was in default and a lender failed under its securities obligations, Ginnie Mae became fully insured. Ginnie Mae, in effect, got the benefit of full insurance.

That was our way of protecting Ginnie Mae's interest at the time. We were not in the position to underwrite the loans. We were not in the position to underwrite in effect a lender's ability to be a coinsurer. So we looked to protect the interest of Ginnie Mae and this was kind of a workout arrangement that made the loans Ginnie Mae-able.

Senator GRAHAM. And from whom did you secure that assurance of full reimbursement in the event of a default?

Mr. LASKO. My personal recollection——

Senator GRAHAM. I didn't mean the individual. I mean what institution?

Mr. LASKO. From basically the folks at FHA at the time, the FHA commissioner and the general deputy and assistant secretary for housing.

Senator **Graham**. I guess my concern is, if the theory of coinsurance was to have another party have some risk and assume some of the responsibilities of an at-risk lender, but if by subsequent actions, such as the one you just described, effectively that risk was eliminated, did that not undercut an essential premise behind the initial decision to utilize coinsurance?

Mr. **Lasko**. The theory at the time was that the sharing of risk still existed because once FHA gave Ginnie Mae the benefit of full insurance, as I recall, the lender itself had to fail and FHA would still have recourse against that lender. So the theory was that the lender's exposure was still preserved.

In retrospect, that may not have always worked out, but at the time there was a theory that held there was still a sharing of risk. There was still an exposure of the private lender, even though Ginnie Mae—another part of the same department—had the benefit of full insurance.

Mr. **Hipps**. If I could add to that, Senator, I agree with what Warren has said. That whole discussion had to do with what happens—not with eliminating the risk of the coinsuring lender, but recognizing that there was a potential of a lender defaulting or failing, what happens to protect Ginnie Mae in the event that this occurs.

As I remember those discussions, the understanding was that in exchange for Housing agreeing that if the mortgage was in Ginnie Mae's hands it would become fully insured. Ginnie Mae's obligation was that with any such portfolio that they acquired, before it was tendered to Housing as a fully insured claim, they would make their best efforts to find another coinsured lender that was willing to purchase that portfolio from Ginnie Mae on a coinsured basis.

So the agreement to fully insure was in essence the bottom line of what happens to it if Ginnie Mae cannot market the property to another coinsured lender as a coinsured loan.

Ms. **Beasley**. Senator, if I could add one comment to that, the reason that Ginnie Mae joined with FHA's coinsurance was primarily to be able to tap the secondary market for capital to flow into these properties because before Ginnie Mae's were used to fund coinsured loans investors in any of these loans would have to underwrite the coinsured lender as well as thoroughly understand the program before they could make such an investment. It was a very inefficient way to raise capital for these particular properties.

So Ginnie Mae mortgage-backed securities, with their AAA rating, were used in conjunction with coinsurance in order to efficiently tap the secondary market. It was not to relieve the coinsurers of risk. In fact, it ultimately did not do that.

Senator **Graham**. We're going to have to leave momentarily for a vote. I'd like to raise one last question on the pre-May 1983 period. We're going to have some discussion later on the issue of how important is coinsurance as a means of assuring an adequate source of financing for affordable multifamily housing. Professor Edelstein in his prepared statement made a very strong case for almost the necessity for coinsurance, if an adequate flow was to be provided.

In the pre-1983 period, was there any assessment made of that question? That is, how important it would be to add a new source of financing into the mix that was previously available in order to meet a national need for affordable multifamily housing?

Mr. Hipps. I don't think that the Department—that was not the decision or the issue that was before HUD and this is not another source of financing. At least it was not viewed that way by HUD at the time. It was viewed as an alternative delivery system for existing sources of financing, i.e. FHA mortgage insurance, and it was clear and had been clear for a number of years that FHA was gradually—maybe even rapidly—losing its in-house capacity to do that which it had done for a number of years—process and issue commitments and close multifamily transactions.

And it was in that kind of an environment, with the belief that for the foreseeable future there wasn't any possibility of rebuilding that capacity, and I would add that in the Reagan years you had the general philosophy to diminish the size of the Federal establishment, those things combined, that made it unlikely that HUD could deliver the programs without finding that kind of an alternative vehicle.

Mr. Lasko. Senator, if I could just make a brief further comment, my recollection goes something like this. Back in 1974 when coinsurance was first enacted, as you've just heard, it was a modest experimental program mainly aimed at refinancing older existing properties. I can remember a lot of studies focusing on the New York area and the focus was on preserving reasonably sound projects, but ones that needed a new roof or a new elevator or something like that. It was a demonstration aimed at urban areas' older properties' preservation.

As Mr. Hipps has been saying, what happened over the years as HUD was looking for ways to downsize it staff and to get out of all the processing, this vehicle was latched onto as a way to have it both ways—to use a program on the books, coinsurance, turn it into a program for processing new construction and substantial rehab, not the light rehab of older properties in Brooklyn, and to get the staff downsized as we went through the period of the early 1980's and very tight budgets. This program which was originally designed for a different purpose became a vehicle to basically downsize HUD and in the process some thing obviously went wrong.

Senator Mack. I could ask a whole series of questions still following up on this. Could we do this when we get back?

Senator Graham. Yes. We will take a recess for approximately 15 minutes. When we reconvene, we will take any final comments on question No. 1 and then proceed to question No. 2 which we've already opened up, which is an assessment of what happened after this program was initiated and what lessons can we learn. We will recess for 15 minutes.

[Recess.]

Senator Graham. I will call the meeting back to order.

There will probably be some further intermixing of comments on question No. 1, but I would like to move to question No. 2, which is, with the benefit of hindsight, what were the flaws in the design and conception of the post-May 1983 coinsurance programs and the related GNMA mortgage-backed securities program?

We've had some comment on that already. Any other additions to what we have learned from this experience?

Mr. LASKO. Since you turned to me, I will make two quick comments.

Senator GRAHAM. Mr. Lasko, my father got into the Angus cattle business because he was sitting at an auction in Ocala, FL, and made a move with his hand, just as you did, and ended up buying Angus cows. So you need to be careful, whether you're in a cow auction or Senate committee room. [Laughter.]

Mr. LASKO. I will bear that in mind.

I think with the benefit of hindsight, a couple things come to mind as to things that were not anticipated when the Ginnie Mae part of the program was designed.

Perhaps I should note that my entire connection with this program was from the Ginnie Mae side and I left Ginnie Mae about 5 years ago, so I'm really not familiar with what's happened since about early 1985.

Two observations come to mind. One is that the mortgage banker who both made the mortgage and then issued the securities, if it turned out in the event of a default on the mortgage and prior to the point when a claim could be made against FHA for insurance benefits, would have very substantial cash drains on itself. My understanding is that in the period of time that it takes to get a claim from HUD and all the work a lender has to do while a claim is filed in attempting to sell the property and so forth has caused enormous cash drains that probably exceeded anything we anticipated at the time. As a result, it has made it difficult for the lender to stay in business during that period of time to live up to its obligations.

Second—and this was an issue at the time I was there—even as between Ginnie Mae and the rest of HUD, there could be disputes that I think were simply not anticipated at the time as to whether an insurance claim by Ginnie Mae against FHA was valid, whether it should be paid, whether there were considerations of a nonfinancial type—just departmental structural considerations as to when and if a claim should be paid. Again, I think that was unanticipated. It had always been anticipated that the relationship between Ginnie Mae and the rest of HUD would be a strictly business relationship. So if a mortgage was in default and met all the requirements of the regs for filing a claim, if Ginnie Mae could do that, the claim would be paid. My understanding is that that's not always happened.

Senator MACK. Mr. DelliBovi, I had asked some questions earlier about the process of establishing the coinsurance program and now we're into some of the flaws. I know you have a prepared statement. Is there some point at which you want to put that in the record or make some comments with respect to the statement that reflect on what we are discussing today?

ALFRED DELLIBOVI, UNDER SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, WASHINGTON, DC

Mr. DELLIBOVI. Yes, Senator. In the interest of time, I would ask that the entire statement be placed into the record and I would be pleased to answer any specific questions you might have as we go through this. Certainly this format is informative to us as well as you. It's not exactly what we counted on this morning, but that's fine and we will work with you in that.

I would just point out that the Secretary's decision to impose the precommitment loan reviews and impose the termination of coinsurance by rule-making is currently the subject of litigation and the Department has invoked its deliberative process privilege in that litigation. Thus, there may be some issues raised, particularly those which would involve disclosure of predecisional analyses, recommendations, and opinions that we will not be able to address in today's forum. Certainly we recognize the subcommittee's legitimate need to pursue its functions and, as always, we will be as forthcoming and cooperative as possible in responding to the inquiries, but there may be a few that we cannot respond to until after the litigation has reached a conclusion.

Senator MACK. There were a couple of questions that came to my mind as Ms. Beasley was making her comments and if I remember now, I was trying to get at where it would have been possible to identify potential problems and who should have identified those potential problems. I think you indicated that basically everyone relied on HUD. They had the expertise to develop these plans.

I guess the one question that comes to my mind is, at what level at HUD are these types of decisions made? As I see it, there probably are many different levels at HUD, but there are those who have been in the system for years who have worked with these programs for years, and then there may be folks that come in that are with HUD for 1, 2 or 3 years. At what levels are these decisions made? What kind of relationships develop there? Is there something we should be looking at toward those relationships to determine if there's a breakdown in communication or is there some adjustment to the system that needs to be made in order to identify where those problems have developed?

Mr. DELLIBOVI. Senator, let me try to respond to that if I may. The coinsurance delivery scheme was intended to enhance and create opportunities in which the Government could work with the private sector and it was a laudable goal.

Now I learned long ago—and you can tell by my accent that I'm a New Yorker, and the head of Tammany Hall at one point at the turn of the century, Senator Plunckett, once described something called "honest graft." He referred to people who see their opportunities and take it.

I think if you look in the current issue of Regardie's magazine, there's a long article on one of the coinsurers, DRG, and the author writes—and I'd like to quote:

> Under the coinsurance program, the Federal Government was putting its full faith and credit behind lenders that stood to benefit from the fees, developers that stood to benefit from the loans, appraisers that stood to benefit from continued business as long as they corroborated developers' evaluations, and underwriters that stood to benefit from processing deals as quickly as possible.

I think that sort of sums it up. This was not an honest privatization strategy, in my judgment. It was a scheme—some would say scam. My staff argued over which word we should put in the testimony. I chose scheme. But the point of the matter was, there were opportunities here and people could see them and take them.

The bottom line—and you have only to look at that chart over there to see who got stuck with the bag and that's the taxpayer—$1.6 billion and rising on defaults, and those people in the private sector saw a profit center here and I'm a privatizer. I fully believe that the Government should encourage privatization, but the Government has to make sure in those efforts that there is accountability and that the thing being profited is not just the Government's money and assets.

Senator **Mack**. This is really not a true privatization.

Mr. **DelliBovi**. To me, this is a scheme that came along, it was there—the Reagan administration, and I was part of it, we were looking for privatization strategies. The administration encouraged it. And somebody conveniently slapped the privatization label on this technique and, in my judgment, because very little was done in privatization at that time, this was the success story that they trotted out. We've all been faced with writing annual reports and term papers or something that tells us that this became the privatization example.

I can tell you, across the street where I was at the Department of Transportation, a scheme like this would have been laughed out of the building if anybody proposed this.

Senator **Mack**. Let me get to that point. Why wasn't it laughed out of HUD?

Mr. **DelliBovi**. I wasn't there.

Senator **Mack**. I'm really trying to touch on some management techniques here. This is not a philosophical debate. I think the question, at least in my mind, from a management perspective, why didn't somebody say, "This is the funniest damn thing I've ever seen?" Why didn't that happen?

PETER H. MONROE, GENERAL DEPUTY ASSISTANT SECRETARY OF HOUSING, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, DEPUTY FEDERAL HOUSING COMMISSIONER, WASHINGTON, DC

Mr. **Monroe**. Well, we finally did.

Senator **Mack**. I'm trying to get back to the time when the decision was made which was the whole reason that I raised the question in the first place.

Let me just ask, should I, as a Member of Congress, have said, "This is the funniest thing I've ever seen?"

Mr. **DelliBovi**. I think anyone looking at this objectively would have realized that the Government had all of the risk here because when used in tandem in Ginnie Mae that's what happened. And the only one who stood to lose was the Government.

Privatization is a sharing. Where is the "co" in the loss? You can see plenty of opportunities for there to be a coprofit. I can't see too much for—the risk was not being shared in this scheme.

Senator **Graham**. I think what Senator Mack is asking is the question—we've described our role, this subcommittee's role, as one not trying to go after the rats but the cheese! So we are trying to understand why this particular piece of cheese was cooked the way it was with apparently a mismatch of ingredients. It may even have had broccoli in the cheese! I don't know.

But what was it within HUD or in agencies that had some oversight over HUD that caused the flaws in this program to go undetected. Professor Edelstein?

PROF. ROBERT EDELSTEIN, CENTER FOR REAL ESTATE AND URBAN ECONOMICS, UNIVERSITY OF CALIFORNIA AT BERKELEY, BERKELEY, CA

Professor EDELSTEIN. Mr. DelliBovi was across the street and I was across the country, so I wasn't there to watch any of this being implemented. But I think there are three separable issues that need to be addressed and I think, if you do that, you can start to see where the problems must have been.

The first one—and I think it's been at least implicitly answered—is why do you want to have insurance or coinsurance? The answer is to access the capital markets and the secondary markets. Without believable insurance for virtually any type of mortgage instrument, you can't securitize it except at a price which doesn't make sense. That goes for Ginnie Mae's, Fannie Mae's, Freddie Mac's, CMO's, REMIC's and the whole lot of mortgage-backed securities.

If we are working on the presumption I am, that you want to help multifamily housing and the financing of it, then the insurance notion must go along with it. The financing of low-income housing is not going to happen otherwise; because you won't be able to access the secondary market.

The second issue relates to whether the concept of coinsurance is a good idea. I think I'm a little ahead of myself in terms of the way you ordered questions, but I would argue that coinsurance is the appropriate conceptual framework for levering efficiently on the private sector.

The third issue is about design and implementation of coinsurance. If you start to ask questions about if the design itself were appropriate, the design refers to risk-sharing, including who will bear the risk in various types of outcomes, you find a lot of problems.

Then if you go to implementation, it appears—and I wasn't inside—that the coinsurance program was used to cut staff in an inappropriate way—cut costs of doing business—when in fact the underwriting functions that were eliminated are the heart of doing business for the coinsurance program when you are going to put the Government at risk. If you do proper underwriting and you have appropriate people actually sharing risk, then you double the incentives for coinsurance success. In other words, because of underwriting inadequacies of HUD, the private sector did not really have something at risk. There were ways for the private lenders avoiding risk sharing; by having subsidiaries that were set outside where someone had money but it wasn't at risk, or basically fraud. If you don't do your homework of underwriting and monitoring the design, even if you put the design in place properly, you get in trouble.

I think it's that third stage—design and implementation—that speaks for itself. I don't know how it happened at HUD, but that's where the questions and issues of coinsurance failure have to be addressed.

Mr. DelliBovi. I would agree, Senator. It's clearly in the design and implementation and in the attempts we are taking to come up with a delegated processing system we are carefully taking steps to do that and it's slow. It's slower than maybe we would like and I think it was Mr. Dale or Mr. Hipps who before the recess pointed out the need to get the product out there, the demand for programs.

I have seen all my life in Government that when a program is legislated, then there's a tremendous demand out there to get it delivered and sometimes people move a little bit more quickly than they would if they were developing a new product in the private sector, for instance, where new products are painstakingly developed. Or even Fannie Mae and Freddie Mac take a little more deliberative approach to getting something new out than Government agencies tend to.

Senator Mack. In your attempt to develop a new program that in essence will delegate, what are you doing differently through this process than what you perceive was done in the earlier process?

Mr. DelliBovi. The first thing is we intend not to delegate the underwriting. We are going to make the ultimate decision in our program to commit the Federal Government or not commit the Federal Government. We think that there's a fundamental flaw in the old coinsurance program and that flaw was that the Government's responsibility was delegated and that flaw—delegating the underwriting—is not fixable. We have to be accountable.

Senator Mack. Let me just ask, somewhere along the line someone said that if you make the coinsurer-lender take a sufficient amount of risk that lender will do a reasonable job underwriting.

Mr. DelliBovi. Mr. Monroe—by the way, I should introduce who I have with me, the Executive Vice President of Ginnie Mae, Robert Kalish, on my right; on your left is the General Deputy Assistant Secretary of Housing and Deputy Housing Commissioner, Peter Monroe. Mr. Monroe is more qualified than I to answer that particular question.

Mr. Monroe. Could I answer it just in the sense that, in my opinion, the real essential problem with coinsurance and its design and implementation is the fact that everybody in the system had incentives to overmortgage. The developer had an incentive to overmortgage because it was a nonrecourse loan. So it was almost like a sale. The larger the mortgage, the more in effect he sold it for. So they are pushing to overmortgage.

The coinsuring lenders were paid up front fees in relationship to the size of the mortgage that they were willing to generate. So they were competing. They were not competing on service. They were competing on who could give the largest mortgage.

And if there was a failure, very little capital was left at risk on their part. So in a sense their whole operation was nonrecourse, too.

Then you go to the secondary market.

Senator GRAHAM. Excuse me. Could I ask a question. Were the mortgages recourse or nonrecourse?

Mr. MONROE. Nonrecourse.

Senator GRAHAM. Why were they nonrecourse?

Mr. MONROE. An excellent question. Those are the mortgages that the industry needed in part to be able to take advantage of some of the old tax laws. You needed nonrecourse financing in order to pass losses through to the private limited partners.

Professor EDELSTEIN. Nonrecourse lending in real estate is very standard. Let's understand that. The ultimate collateral is supposed to be property. So if you don't underwrite it properly in terms of an appraisal—now I'm separating from the fact that sometimes markets disappear from under you. If you go to Texas, you could be the best appraiser that ever lived and if you wrote an appraisal in 1981 you got a very different answer from 1985 and it's not because you had done anything wrong; you did it to the best of your knowledge in a sophisticated way.

But abstracting from that, that markets disappear and markets change very rapidly in a volatile regional economy, if you underwrite real estate properly, the property stands there. If you give an 80 percent loan or a 70 percent loan and markets usually don't fade by 30 percent or 20 percent and if the coinsurer has resources and some of the top of the risk; so the lender is taking right off the top of any sharing after that, Government doesn't have very much at risk except when markets really crash. Maybe that's the risk that Government should accept. The Government should insure those types of catastrophic events—economic catastrophic events.

But if you have a system where you can issue loans for more than the property is worth, then there isn't enough collateral; and if you have nothing at risk—or if you have a lender that has something at risk and he overlends, he could be in trouble. But that's the problem. The underwriting has to be done initially very carefully and I think the argument is going to come up that 100 percent insurance is the right way to go because you're taking the risk anyway. It's the wrong answer with the right set of facts.

Coinsurance is the appropriate method because you change the incentives for the people who are lending in a way that won't happen if there's 100 percent insurance. If as a lender I am at risk for something and I don't have 100 percent insurance, then I have to worry that you can come after me either legally if I've done something criminal, or after my capital when I have capital at risk. So capital adequacy in some form or some sort of lender or property collateral has to be there.

You can do better with coinsurance than with 100 percent insurance because when you change the lender's behavior—just common sense. If I tell you that I protected you from any type of risk, you can be lazier!

Mr. MONROE. Just to pick up what I was saying, the incentives—the developer had an incentive to overmortgage. The coinsuring lender had an incentive to overmortgage and very little capital at risk. And the final straw was that the secondary market, which normally would also have an incentive to make sure that this wasn't overmortgaged, lacked that incentive because of the fact that FHA in turn indemnified Ginnie Mae. So we're the only people at risk and we didn't delegate—we abdicated. This is an abdicated underwriting system. We abdicated the underwriting to the private sector and it was just simply as a result no control on the size of the mortgages and, in effect, the coinsuring lenders in many circumstances—and certainly not all—but in many circumstances were able to float junk bond quality mortgages at AAA bond rates. So, to me, that was really the problem.

And I share a number of the views there that the key here is to make sure that when any new system that we come up with, that there is some control on the actual underwriting—on the valuation of the properties—that really works. I think the Federal Government has to have an ability not to abdicate and not to delegate but to really have a look and control the valuation process.

Senator **Mack**. Where did the system break down in the sense that on the surface it appeared that a coinsurance lender was in fact going to be at risk because of the 80 percent factor? Where did it break down? What was the key point there?

Ms. **Beasley**. I think the problem that has come about recently is the coinsurers are still at risk. They've always been at risk. But many of them were undercapitalized and so when they default on that first Ginnie Mae pass-through on Ginnie Mae mortgage-backed securities, Ginnie Mae takes the whole portfolio and they are out of business.

I have to respectfully disagree with our partners from HUD. We are very much at risk and a number of coinsurers have risked their careers and their businesses to participate.

But the reason coinsurance came about in the first place is that HUD was doing a terrible job in getting capital into housing. The field offices weren't functioning. The subsidy programs had been cut dramatically. HUD staff had been cut dramatically. And coinsurance seemed like a good idea at the time. That's why it was not laughed out of the building.

Had it been properly monitored, I believe it still could have stayed a good program, but there was no political will at HUD at the Secretary's office level in the prior administration to monitor it properly. MBA wrote and asked for more monitoring. A lot of people were concerned.

Even so, I think if you take the defaults of one major lender out of the statistics and look at the defaults that are left, you will find a default history that is very comparable to HUD's full insurance program. So $10 billion of loans were produced at default rates that are very similar to the default rates that HUD produced under full insurance and I think the glass is still at least half-full.

Senator **Graham**. Mr. Monroe.

Mr. **Monroe**. While I would have agreed with Gaye on the comparability to full insurance a while ago, as you see by the just skyrocketing default rate over there [pointing to chart] in the section 223(f) program, the program default rate on relatively new mortgages is now 20 percent. In the new construction program, the default rate over the last 6 months has gone from 5 percent to 14 percent. We have just dramatic problems here relative to full insurance as it now turns out and it's still going on.

I believe that we have a fundamental problem here in that, unlike single family housing, it's very difficult to delegate underwriting in multifamily for a number of reasons. Just the nature of the valuation process itself is very different in single family than in multifamily. In single family you look for comparables and that's fairly easy to check. In the case of multifamily, where you really get into the cat and mouse game is when you start tinkering with cap rates and just stretching the rents a little higher and cutting the expenses a little bit lower. It's much more subject to abuse.

The other problem is, unlike single family—because you know we delegate the underwriting in the direct endorsement program—one large loan in multifamily can be a huge risk, whereas you have diversification of risk in single family.

So for both of those reasons, it's a lot easier to monitor. It makes more sense to delegate underwriting in single family than in multifamily. Just the riskiness of multifamily itself makes delegation a big problem. To me, that is one significant aspect of the fundamental flaw of delegating to the private sector in multifamily.

Senator **GRAHAM**. Within that, at one of our previous hearings it was stated that another delegation under coinsurance was to determine what the fair market rents were for a particular project. This came up particularly in the case of a section 8 project. Was there a general delegation to the coinsurer to determine fair market rents?

Mr. **MONROE**. That's one of the most complex areas of mankind, the interrelationship between coinsurance and mod rehab, but what you're referring to is the rent-setting process for purposes of determining the contract rents under the section 8 program mod rehab versus the setting of the rents for purposes of determining whether or not that rent level is really in the market and can ultimately support the underwriting of the project's value. So they are different issues.

Senator **GRAHAM**. Well, the issue here is, since the Government is going to pay all of the section 8 rent after the tenant has put up 30 percent of his income, the Government has the ability to control what the revenue stream for the project will be. It becomes a chicken and egg situation.

We were told that that authority to set the rent level, to determine what fair market rents were, was delegated to the coinsurer. (a) Is that an accurate statement? (b) Was that peculiar to section 8 projects or a general delegation for all section 223(f) projects?

Mr. **MONROE**. First of all, just one distinction and I'll try to answer it and if we could get you an answer in writing it might be a wise idea.

[The following information was subsequently submitted for the record:]

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United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, DC 20510-6075

April 9, 1990

Honorable Jack Kemp
Secretary
U.S. Department of Housing and Urban Development
451 Seventh Street, S.W.
Washington, D.C. 20410

Dear Secretary Kemp:

As I indicated to Under Secretary DellaBovi and other HUD representatives at the Subcommittee's March 27th roundtable discussion of co-insurance, the Subcommittee desires to pursue certain questions that the discussion and written testimony either raised or did not fully answer.

The Department's written testimony prepared for the March 27th hearing did not specifically address the questions that were stated in the Subcommittee's February 22, 1990, letter inviting HUD to participate in the hearing. I appreciate that certain questions asked the Department to describe its deliberative process in conducting its evaluation of the co-insurance programs. I understand that the Department is sensitive to those specific questions in light of the pending litigation.

We have restated our questions in light of our awareness of the Department's concern over protecting its deliberative process in connection with the evaluation of the co-insurance programs. We, also, have added several questions that arose from the March 27th roundtable discussion or review of the written testimony. Our questions are attached.

I would appreciate a full and complete response to these questions by April 23, 1990. If it would facilitate an expeditious response that is also efficient from the Department's point of view, the Subcommittee staff would be happy to arrange oral depositions of representatives of the Department who are mutually identified. We do need to get prompt and specific answers to our questions, and we will work with you to do this in the way most convenient to the Department.

I look forward to the Department's renewed cooperation with the Subcommittee.

Sincerely,

Bob Graham

Bob Graham
Chairman
HUD/Mod Rehab
Investigation Subcommittee

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-1000

OFFICE OF THE ASSISTANT SECRETARY FOR
LEGISLATION AND CONGRESSIONAL RELATIONS

May 25, 1990

Honorable Bob Graham
Chairman
Committee on Banking, Housing and
  Urban Affairs
United States Senate
Washington, DC 20510-6075

Dear Mr. Chairman:

On behalf of Secretary Kemp, thank you for your letter of April 9, 1990 concerning FHA's multifamily coinsurance programs and the related GNMA mortgage-backed securities program. Your letter sought additional information on these HUD programs to supplement Under Secretary DelliBovi's written testimony prepared for your Subcommittee's March 27, 1990 roundtable hearing on coinsurance.

The enclosed materials respond to each of the questions raised in the attachment to your April 9, 1990 letter. I trust that you will find this information useful in completing your investigative tasks.

Very sincerely yours,

Timothy L. Coyle
Assistant Secretary

Enclosures

FLAWS IN THE DESIGN AND CONCEPTION OF THE POST-MAY 1983 COINSURANCE PROGRAMS AND RELATED GNMA MORTGAGE-BACKED SECURITIES PROGRAM

1. What do HUD records, including budget documents, disclose as to the assumptions made regarding staff resources necessary to implement the co-insurance programs at the time they were initiated by HUD? What savings in personnel costs were projected?

Staff cutbacks and projections of personnel savings were not factors in development of the original 223(f) coinsurance program. The 1980 program was tailored to depository (conventional) lenders who did not want to deal with HUD field offices. During the late 70's when Section 8 production was the top priority for Housing field staff, there were frequent instances of two-year processing delays for 223(f) fully insured applications. 223(f) Coinsurance for Private Lenders was created to provide timely processing while neither adding field staff nor upsetting Section 8 production. Note the comments of the New York City Community Preservation Corporation referencing "The coinsurance program, by its potential virtually to eliminate the substantial FHA processing delays which now occur..." At the same time, HUD had been searching since the heavy insurance losses of the early 1970's for ways to increase lender responsibility and reduce the risks of full insurance. These concerns led to adoption of the Section 244 coinsurance authority in the HCD Act of 1974.

2. What do HUD records disclose as to the Department's reasoning for, first, in July 1980 excluding non-depository institutions from participation in the Section 223(f) coinsurance program and, then, in May 1982 removing this exclusion?

The multifamily coinsurance program was initiated in 1978 (proposed rule -- "Coinsurance for Private Mortgage Lenders" -- published for comment on September 26, 1978) as a program restricted to insured depository institutions. A final rule was published on July 2, 1980, during the Carter Administration. This was a tightly focused specialized program intended to provide (quoting the Preamble) "a delegated processing vehicle enabling supervised lenders to write new mortgages on existing housing in neighborhoods within their service areas and thereby foster preservation of the rental housing stock." Also, in late 1979, the General Accounting Office recommended Federal, state, and industry action to address an acute shortage of affordable rental housing due to abandonment and condominium conversion. According to the GAO, which urged preservation as well as new construction, 41% of rental inventory was 40 years or older and 64% of those units were occupied by families with incomes of less than $10,000.

The final rule published in 1980 provided:

1. Portfolio restriction: To avoid the risk that the program would become a dumping ground for shaky loans in lender portfolios, HUD required that only 1 in 4 of the coinsurer's originations per year could be portfolio loans (and these had to be current and not in default/foreclosure for at least two years prior to insurance).

2. Secondary market: The final rule prohibited reinsurance and transfer to another lender of the originator's coinsurance risk share. Comments by the S&Ls, savings banks and other lenders had favored greater flexibility, at least allowing the originator's risk share to be transferred to another eligible 223 (f) coinsurer.

3. Repair ceiling: To avoid application of Davis-Bacon prevailing wages, the final rule restricted the amount of rehab to the greater of $3,000 per unit, or 15% of property value after rehab. Commentors suggested that the per unit limit should go up to $20,000 for high-cost areas.

In addition to these structural inhibitions, the adverse monetary cycle of 1980-82 kept the supervised depository institutions out of the FHA market (i.e., long-term, fixed interest rate lending). The program was rendered useless when the FHA interest rate ceiling spiralled from 12% in July 1980 to its cyclical peak of 17-1/2% in September 1981.

As interest rates began to recede, HUD was urged by mortgage bankers to: (1) provide a secondary market facility (i.e., funding of coinsured loans through the issuance of GNMA mortgage-backed securities); and (2) permit participation by non-supervised, non-depository lenders (i.e., mortgage bankers). HUD acceded to these requested changes in 1982. By the time interest rates receded to workable levels in 1983, 223(f) coinsurance had become a standard FHA/GNMA mortgage banker program.

3. What do HUD and GNMA records disclose as to the risks that GNMA recognized it was assuming, when it agreed to guarantee securities backed by coinsured loans?

GNMA recognized that it was assuming minimal risk when it agreed (in 1982) to guarantee securities backed by coinsured loans because of certain provisions in the coinsurance regulations that provided for indemnification, possible conversion of all coinsured loans to full insurance and the assignment of all defaulted loans, after conversion, to FHA. The principal cost recognized by GNMA as non-reimbursable was the one-percent assignment fee required after conversion to full insurance. Pursuant to the coinsurance regulations, it was understood that FHA would reimburse GNMA for all other costs paid by GNMA to securities holders with respect to any coinsured mortgage that backed the securities.

HUD's potential losses from the coinsurance program were compounded significantly with the passage of the 1987 Housing and Community Development Amendments and the 1988 McKinney Act, which amended Section 203 of the 1978 Housing and Community Development Act. The Section 203 amendments apply to all projects that HUD forecloses and sells, including projects with defaulted coinsured loans which GNMA is entitled to convert to full insurance and assign to FHA. The Section 203 amendments effectively forced conversion of market-rate housing into subsidized low-income housing by requiring HUD to provide project-based Section 8 assistance for all vacant units and all units occupied by income-eligible tenants.

4. Does HUD concur with the description of the conceptual flaws in the coinsurance programs and related GNMA mortgage-backed securities program that is stated in the Price Waterhouse audit of the FHA insurance funds for fiscal years 1987 and 1988 and in the Price Waterhouse January 18, 1990, report to HUD on the coinsurance programs? If HUD does not concur in any material respect, please explain why.

HUD concurs with the Price Waterhouse findings.

FAILURES IN THE IMPLEMENTATION OF THE POST-MAY 1983 CO-INSURANCE PROGRAMS AND RELATED GNMA MORTGAGE-BACKED SECURITIES PROGRAM

1. Which co-insurers were permitted to establish a corporation that held the co-insurance liability separate from the lending, loan servicing, and other business operations of the co-insurer entity's affiliates? What do HUD records disclose as to the Department's reasoning in permitting this separation?

DRG Funding Corporation was permitted to enter into an advisory agreement with its parent, DRG Financial Corporation. Under this agreement, Financial was to provide Funding with its mortgage banking experience and use of its facilities and personnel to assist in the loan underwriting process. As compensation, Financial received a non-refundable application fee equal to 0.3% of the mortgage amount sought and a financing fee generally equal to 2% of the coinsured mortgage amount. The application fees were collected by Funding and passed through to Financial. The Financing fees were paid directly to Financial at closing. The coinsurance liability was held by Funding. Clearly, this arrangement permitted the "upstreaming" of assets (income) to the parent corporation, while keeping the liabilities with the subsidiary which was the approved coinsuring lender. We can discern no rationale for permitting this arrangement.

It should be noted that DRG is the subject of an ongoing criminal investigation by the FBI. All of HUD's files of correspondence with DRG are now in the possession of the FBI.

We have no specific information indicating that other lenders engaged in similar arrangements. However, it is now common knowledge that HUD's weak capital requirements permitted the "upstreaming" or distribution of most coinsurance income, leaving lenders with little capital at risk.

2. (a) Do HUD records reflect that there was a significant variation in the multifamily lending experience and length of period of business operations among the participants in the co-insurance programs?

Yes.

(b) If there was such variation, do HUD records disclose that HUD has experienced a higher incidence of loan defaults or issuer defaults among those co-insurers with less experience and a shorter operating history?

There is no discernable relationship between companies' lending experience and length of operating history and incidence of loan defaults or issuer defaults.

3. What do HUD records disclose as to the ability of DRG Funding Corp. and York Associates, Inc. to co-insure loans under the Section 223(f) or 221(d) program prior to the completion by other co-insurers of their three test case reviews? What volume of co-insured loans did DRG and York originate between May 1983 and May 1985? During this period what percentage of total co-insured loans did this represent? What do HUD records disclose as to the willingness of DRG or York to engage in lending practices (such as overmortgaging) that encouraged borrowers to do business with it rather than other co-insurers? What do HUD records disclose as to HUD's ability and willingness to regulate such practices?

Like other lenders approved to participate in HUD's multifamily coinsurance programs, DRG Funding Corporation and York Associates demonstrated their ability to underwrite Section 223(f) coinsured loans by submitting three "test cases". HUD reviewed and approved these test cases prior to granting DRG and York authority to underwrite and issue commitments for coinsurance.

The following table provides a breakout of 223(f) coinsured loans closed between May 1983 and May 1985 and shows that DRG and York together were responsible for approximately 95% of all 223(f) coinsurance activity. It should also be noted that neither of these lenders ever applied to participate in the Section 221(d) coinsurance program.

SECTION 223(f) COINSURANCE ACTIVITY
MAY 1983 - MAY 1985

Lender	Loans Closed	Percent of Total	Mortgage Amount	Percent of Total
DRG	104	46.6%	$545,532,400	46.4%
York	109	48.9%	569,524,200	48.4%
Other	10	4.5%	61,229,300	5.2%
TOTAL	223	100.0%	$1,176,285,900	100.0%

Because of serious underwriting deficiencies, including overmortgaging, HUD placed DRG and York on probation in November 1984. HUD lifted the probations and reinstated both lenders in May 1985. Copies of HUD's letters to DRG and York concerning the imposition and lifting of these administrative sanctions are attached.

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Linda 614

cc:
HMII:BOWRIN:CHRON:6138
HMI:HAMERNICK:6134
HM:DEBARTOLOMEIS:6106
HPAS:9110
LENDER CERTIFICATION
ECAN:6158
HMIT:CHEATHAM:6162
HMII:BOWRIN:cak/lgr:10/30/84 426-7113 (Coinsurance Disk)

Mr. Donald DeFranceaux
President
DRG Funding Corporation
1199 30th Street, NW
Washington, DC 20001

Dear Mr. DeFranceaux:

As you are aware, members of my staff visited the Colonial House project in Houston, Texas prior to endorsement because of concerns expressed by the local office relating principally to the extremely soft market in Houston (the location surrounding the subject property shows an overall vacancy rate of approximately 20 percent) and the history of this project, its location and size. The appraisal subsequently performed by a senior member of my Headquarters' staff revealed, among other things:

1. This project is ineligible for insurance under Section 223(f). The 223(f) coinsurance instructions require that a project must reach sustaining occupancy within 12 months of endorsement. For this 1,818-unit project with an approximate 200-unit occupancy (as of the week of September 17 - 21) to reach sustaining occupancy by September 1985, an absorption rate of three to four units a day would have to be realized. It is unjustifiably optimistic to expect this rent-up rate at the rents used in your underwriting under current Houston housing market conditions.

2. In order for this project to meet HUD programmatic requirements, rents would have to be reduced by amounts that could attract the absorption reflected above. The reduced rents would, of course, result in a significantly reduced mortgage amount and property value. Assuming HUD were willing to waive the requirement for a sustaining occupancy within 12 months after endorsement, a more realistic rent-up period of 3 to 5 years and the establishment of a 3-year operating deficit escrow would have to be recognized in processing.

3. There are serious underwriting deficiencies relating to your determination of the value of the property and the processing rents, both of which greatly exceeded the determinations arrived at by the Headquarters' appraiser.

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BOWRIN	SANDERS	LECLAIR	HAMERNICK	DEBARTOLOMEIS

4. All of the required repairs were not completed prior to endorsement and some units were not ready for occupancy. Neither the regulations nor the handbook instructions permit repairs on refinancing transactions to be completed after endorsement unless the repairs cannot be completed because of weather conditions. Weather was not a factor in this case.

In addition, a repair escrow was also permitted in the Georgetown Apartments project in Dallas, Texas. As stated above, regulations governing the 223(f) coinsurance program do not permit such repair escrows in refinance transactions. However expedient, violations of the regulations are not permitted.

Further, the Palm Lake Apartments project involved the sale of tax exempt bonds. The costs associated with this sale were apparently included in the mortgage transaction, in violation of HUD policy. HUD policy requires that any such costs beyond the usual permitted fees of 3.5 percent (3.8 percent in coinsurance) be an out-of-pocket expense and not be included in the mortgage.

The instances cited above are considered serious breaches of the authority granted you under the 223(f) coinsurance program. You are, therefore, advised that until further notice, in accordance with Chapter 2, paragraph 7 of HUD Handbook 4566.1, your authority to underwrite 223(f) coinsurance loans independent of our review, is hereby suspended as of the date of receipt of this letter. Effective immediately, all cases for which you have not issued a firm commitment must be sent to this office for review and approval of the complete processing (including the same documentation as was required for our review of the first 3 cases) prior to issuance of a commitment.

Sincerely,

Maurice L. Barksdale
Assistant Secretary

7110

THE SECRETARY OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410

MAY 10 1985

Mr. Donald DeFranceaux
President
DRG Funding Corporation
1099 30th Street, NW
Washington, DC 20007

Dear Mr. DeFranceaux:

The purpose of this letter is to delineate HUD's position on DRG's status as a coinsurer under the Section 223(f) coinsurance program. By letter dated November 13, 1984, HUD informed you that DRG Funding no longer had the authority to issue conditional commitments and that all future cases would have to be submitted to the Department for review prior to the issuance of a commitment. This requirement was imposed as the result of our review of your operations, particularly the processing of Colonial House in Houston. Since that time, you have submitted 17 cases for our review. We have finished the review on most of these cases and provided written comments to you. You are authorized to issue commitments on these cases once you have complied with our comments. In those cases in which you have not yet received our comments, you are authorized to issue mortgage insurance in accordance with standard underwriting procedures.

You have been advised that the majority of these cases were unacceptable as processed. We have not, in fact, found the improvement in processing policy or procedures which we had hoped to find. We have found the process useful, however, in that it has provided a relatively clear indication of where your particular problems lie, how these errors may be occurring, and what specific corrections should be made. This letter provides a comprehensive listing of these areas and detailed discussion of the issues involved.

Please review this listing immediately. If there are any areas that you do not understand, please call my staff and arrange for a meeting to clarify the issue. If we do not hear from you within three days, we will assume that you understand HUD's requirements with respect to coinsurance and that you will abide by them.

Problem Area: Use of Non-HUD Approved Personnel

We have approved hundreds of cost analysts, architects/engineers/inspectors, and appraisers for your company. In fact, you assembled resumes for and submitted for approval, at one time, 349 fee engineers and architects to perform architectural and engineering services under the Section 223(f) coinsurance program. Notwithstanding, you continue to use, in violation of regulations and handbook requirements, non-HUD approved personnel to process cases. (Since we have not completed our review of the 549 resumes, in the event the processor is not on the approved list, our practice is to check the name against the resumes submitted. What we have found is that in addition to the processors not being approved, a request for approval is not even pending.) Examples are: Parkside Apartments, Lorna Doone Apartments, and Alhambra/Crestwood.

This practice must cease immediately.

Problem Area: Financial Analysis

None of the cases submitted for precommitment review has contained a financial analysis worksheet, nor any evidence that financial statements had been analyzed. Rather, you have submitted a narrative which is part of the underwriter's report, which addresses the mortgagor's capabilities, experience and financial capacity. These assessments appear to be based on personal knowledge rather than documentation as there has been nothing in the files to support the statements. In Chestnut Crossing and Autumn Crest, you appear to have acknowledged that the principals could not meet the financial requirements based on their current financial capacity by stating that the financial requirements could be met with syndication proceeds. (In Autumn Crest, we did our own financial analysis and determined that with or without syndication proceeds, one of the principals did have the financial capacity to meet the cash requirements.)

Your approach to the financial and credit analysis requirement indicates that you place little importance on this part of the underwriting process, when, in fact, it is one of the more important aspects. The ability of the principals to meet the initial cash requirements as well as to meet contingencies should they arise is an important concern in determining whether to insure a loan made to them. We acknowledge that the insurance business involves risks, but one must determine that not only is the security offered adequate, but that the principals are acceptable financial and credit risks.

Syndication proceeds receivable from other projects can be relied upon in determining financial capacity provided:

a. they have not been pledged as security against other liabilities (which is often the case) and

b. they will actually be realized by the time the financial requirements of the project under review have to be met.

Syndication proceeds receivable from the project under review may not be relied upon as evidence of financial capacity since they are not assured.

Similarly, letters of credit or letters of intent to issue letters of credit may also not be considered as evidence of financial capacity. A firm commitment issued by the Federal Government or you as our agent signifies that all aspects of the underwriting process have been evaluated and that the project is a "go-deal." Failure to adequately analyze the financial and credit aspects of a proposal violates this principle. You must analyze the financial statements, paying particular attention to the working capital, and conduct a thorough credit investigation. The effects on working capital of contingent liabilities and the financial requirements of other projects in the planning stage or under construction must be considered. If your analysis indicates insufficient working capital to meet the financial demands of all projects, you may look at the sponsor's ability to use fixed assets to secure a loan and may approve an application based on "true net worth" rather than on working capital. In Section 223(f), we anticipated that the financial requirements on some projects would be considerable, and determined to give the sponsor an opportunity to tell us its plan to meet these requirements. The sponsor's financing plan must be evaluated for reasonableness in conjunction with the submitted financial statements. In summary, you cannot issue firm commitments until and unless a thorough credit investigation and a financial statement analysis have been completed on each principal as required by Handbook 4470.1, which evidences the sponsor's credit worthiness and ability to meet the financial requirements.

Problem Areas: Rental Analysis

Contract appraisers frequently fail to identify all rent increasing and decreasing features of the rental comparables used. The rental analyses usually consist of narrative analyses that support an opinion of rental value rather than a comparative analysis showing the adjustment process used to arrive at an estimate.

During renovation, properties are sometimes converted from central (Master) meter to separate meter, whereby tenants pay separately for heat and electric utilities. Often, under such circumstances, the processing rents are unwarrantedly increased following the renovation period; whereas, in actuality, rents may have to be more substantively reduced when utilities are paid by tenants in order for the project to remain competitive.

The appraisal reports often do not comment on whether existing leases permit pass throughs of rental increases attributable to the completion of major capital improvements. If not, no rental increases could occur until the existing leases expire. This situation could significantly affect the value of the project, the maximum mortgage amount, and the requirement that sustaining occupancy be reached within 1 year.

In areas where rent control legislation is in existence, such as the case of Crystal Apartments in Hollis, New York, we have no assurance of the amounts of a rental increase that will be approved by the local rental authority as a result of completion of major capital improvements. Frequently, the fee appraiser does not fully reflect this risk in the rental analysis. Moreover, the time required for completion of the renovation work and the approval of the rental increase by the local rental authority is not properly accounted for. At a minimum, an escrow amount which could be used to reduce the mortgage amount should be provided in all cases where the projected rental increase based on major capital improvements is not approved by the rental authority before closing.

There has been a tendency for the processing (e.g., Lorna Doone and Chestnut Crossing) to pass on to the tenants the total cost of proposed repairs. Adjustments are often made to rental comparables in amounts that are sufficient to provide enough income to amortize the additional mortgage amount required to support the repair costs. Many repairs are maintenance type or replacement items that will enhance the rent producing capability of the project in some amount but not necessarily by an amount equal to the cost of the repair. The amount of rental value attributable to repairs can best be determined by analyzing comparables not requiring the repairs. Recurring type costs such as maintenance and replacement type items are necessary to maintain the rent desirability of a project and in most instances keep it on a competitive level with other successfully operating projects rather than increasing rents over the competition.

There are instances where rent comparables are not selected on the basis of comparability of similar type units in competitive locations. There have been cases (Four Seasons, Lorna Doone and Chestnut Crossing) where selection appeared to have been on the basis of higher rent levels due to superior locations. Differences in physical characteristics due to poor selection are not always properly addressed by appropriate adjustment. In the above cases, local data was ignored. However, we recognize there are situations where local data is unavailable and it will be necessary to obtain data from superior locations. In these instances, proper adjustment must be made for the difference in rent attributable to location.

Proper completion of a comparative rental analysis, showing all rent inducing and inhibiting features between the comparable and the subject, will prevent the above concerns from recurring.

Problem Area: Expenses

Expense analyses are generally sketchy and poorly documented.

Fee appraisers frequently estimate current project expenses after a repairs/renovation program that are significantly below the past operating history of the property. Often, management fees are tailored to the project instead of being based upon typical experience found for competitive projects. Too often management fees are established on an identity-of-interest basis. The management fee used in the expense estimate should be one that a competent and competitive project management firm would charge a project to provide prudent and typical management services. Management contracts offered at less than typical fees are often short-term or are made with an understanding that compensation can be made under other identity-of-interest services.

In the case of Crystal Apartments, the tax abatement was for a period less than the term of the mortgage. This resulted in the mortgage being overstated. Proper processing requires a mortgage amount permitted by the debt service criterion on Form HUD-92264-A to be first computed using the full tax expense. To this should be added the additional mortgage amount that can be supported by debt service using 100 percent of the tax abatement for the term of that abatement at the interest rate of the insured mortgage. The mortgage amortization plan must be adjusted upward for the tax abatement period.

In those cases (e.g., Northbridge and Four Seasons) where project processing reflected completion of repairs, the reduction in the expense attributed to the repairs component was too optimistic and thereby understated the expense estimate for the projects. In such cases, the processing reflected optimistic reductions in operating expenses while not reflecting a concomitant reduction in project rents.

Not only is the above practice an inconsistent form of processing of PBE allowances, but also the PBE estimates themselves were unrealistic.

Both rents and expenses for the project should reflect the same level of PBE allowances paid by the tenants.

In the case of Lorna Doone, as well as Four Seasons and Northbridge Apartments, a poor selection of expense comparables was made. For example, in Salt Lake City, Utah, one comparable was a 10-year old project located in a suburban area 22 miles away from the subject property which was a 50-year old inner-city project. Thus, there was no comparability between the subject and the expense comparable selected.

In view of the above, the expense analysis supporting the underwriting must be improved to be consistent with both the letter and intent of the Department's underwriting instructions.

Problem Area: Capitalization Rates

The appraiser is frequently unaware of the current interest rate and mortgage term to be used in project processing (e.g., Crystal Apartments). The fee appraiser used 12.75 percent interest rate in processing. The correct rate used on the computerized Form HUD-92264-A by DRC was 13.50 percent. The fee appraiser, for obvious reasons, must be advised of the correct terms of project financing by the mortgagee at the time of the receipt of the appraisal assigument. A full understanding of the assignment is critical to achievement of a quality product.

The use of discounted cash flow analysis continues to be a problem in reports submitted by fee appraisers. Example: Bloomfield Corners, Pontiac, Michigan. This technique, which involves the use of future projections of cash flows and future reversionary value of the property, is not appropriate for mortgage underwriting purposes. This technique is especially susceptible to manipulation and misuse. A quotation from the Winter 1983 issue (Volume 12, No. 4) of the Real Estate Review best sums up the problems associated with the use of a technique sans an intent to maintain market and/or mortgage underwriting reality. Mr. Victor G. Trapasso, one of the District's leading developers says:

> "What is actually quite astonishing is that all too often, an investor bases his decisions on an esoterically propounded multiyear mathematical model of his project only to find out, to his chagrin, that although a rate of return projected by such modeling was expressed with an accuracy to three decimal places, the model was in fact based on assumptions, the realistic variability of which was at least 20 percent. Worse, yet, it comes as a shock to many that sophisticated project models frequently fail utterly to measure the sensitivity of return rates to uncontrollable operating factors like tenant vacancies, mortgage interest fluctuations, and variations in major operating expense factors such as utility rates. IRR projections, for example, frequently make assumptions about inflation rates and sales figures for periods of ten years or more."

In view of the above, discounted cash flow analyses and Internal Rate of Return procedures must not be used in appraisals made for the purpose of underwriting coinsured mortgages.

Problem Area: Sustaining Occupancy

Contract appraisers do not express an opinion as to the period of time required to reach a sustaining occupancy. They should be advised of the 12-month HUD requirement and make a definite statement as to their best estimate as to when the project will reach a sustaining occupancy position. It is essential that the appraiser estimate the period of time to reach a sustaining occupancy so that proper operating deficit calculations can be made. In areas of soft market conditions such as Oklahoma where the Greenery is located, failure to properly estimate the time required to reach a sustaining occupancy will either result in a default or unanticipated excessive costs to the mortgagor to maintain operation of the project.

Problem Area: Information Included With Appraisal Assignments

Too often, the processing appraiser is not provided with adequate information to properly complete the assignment. Accordingly, you, as coinsuring lender, should include the following with appraisal assignments:

1. A copy of the most recent properly completed Form HUD-92013.
2. The statement that the function of the appraisal is to provide reliable facts and estimates which will be used to determine the maximum supportable mortgage to be coinsured by DRG and HUD.
3. The fact that the loan coverage requirement for net income is 1.1765 (equivalent to the debt service ratio of .85).
4. The degree of documentation required to support the three approaches to value.
5. The interest rate and term of the proposed mortgage.

Problem Area: Property Insurance Requirements

In Section 223(f), you are required to establish the amount of property insurance coverage to be maintained by the mortgagor for each building and the entire project. The amount of the insurance must be sufficient to protect our interests against fire, vandalism, malicious mischief, floods, where applicable, and other contingencies covered by a standard permanent insurance policy. Further, given the amount of repairs permitted under the program, you may also need to require Builders Risk insurance which covers the repair period. Regardless, the guidelines for the kind of insurance required are found in Form FHA 2447, Property Insurance Requirements, and the instructions for determining the minimum amount of insurance required are found in Handbook 4480.1, page 92329.

The reasons for requiring adequate hazard insurance and the consequences of not having adequate coverage are obvious. Yet, despite repeated instructions to you, you consistently significantly underestimate (in all cases except one where you overestimated the requirement by over $12 million) the property insurance requirements. Examples follow:

Project Name	DRG Estimate Insurance Required	Correct Amount Insurance Required	Under Insured
Northbbridge	$12,325,000	$15,536,000	$3,211,000
Lorna Doone	$ 3,119,796	$ 3,695,000	$ 575,204
Autumn Crest	$ 7,000,000	$10,745,000	$3,745,000
Laurel Crossing	$ 4,420,000	$ 5,031,475	$ 611,475
Alhambra/Crestwood	$ 2,371,260	$ 2,988,000	$ 616,740

You must follow the aforementioned instructions and correctly estimate the property insurance requirements. Each of our letters to you has included the correct calculation. You should refer to these letters as well to avoid making the same mistakes again.

Problem Area: As-Built Survey and Legal Description of Property

No case that has been submitted to us for precommitment review has included an as-built survey, a legal description of the property or a surveyor's certificate. Despite the fact that this specific comment has appeared in all letters returned to you, DRG did not include these exhibits in the package submitted for our review. We will assume that the exhibits are in your files and have been reviewed by your staff. The importance of these documents cannot be overemphasized. In order to protect the Secretary's interests, we, and DRG through delegation, are required to determine that the property offered for security is, in fact, available to be offered. Part of that determination is the review of the aforementioned documents to assure that the improvements are within the legal boundaries of the site. If any portion of the improvements are outside the project boundaries, the project is uninsurable unless legal arrangements are made to protect the Secretary's interests.

Problem Area: Intent and Commonality of Goals

No amount of documentation, review or discussion can correct rent, occupancy, expense, or capitalization deficiencies attributable to intent associated with disparate goals. A quality end product, especially in the valuation portion of underwriting, which deals with so many variables and relies so heavily on experience and judgment, is impossible to achieve without a genuine desire to do so. Additionally, such a desire must be coupled with a basic agreement of what constitutes quality. The Department's regulations and handbooks are dedicated to promulgating quality underwriting and are adequate if combined with proper intent. It should also be pointed out that accepted industry practices are compatible with Departmental intent and, if adhered to conscientiously, would also lead to a quality product. Accordingly, it is absolutely essential that the Department's coinsurance agents approach this program with the sincere intent of producing quality underwriting. Requirements dealing with documentation should not be construed to be additional bureaucratic stumbling blocks, but rather should be viewed positively as requirements which have evolved from past practical experience that focus needed attention on potential problem areas. Such requirements are intended to be guides or checks to preclude oversight or unwarranted deemphasis of areas critical to the quality that is required for reasonable underwriting.

Our review and the above discussion of the deficiencies noted and corrective action indicated should enable DRG to comply with HUD's coinsurance program requirements. Accordingly, we are releasing you from the requirement that Headquarters review each case prior to issuance of a commitment. Of course, we expect any case you close to comply with the detailed guidance provided herein.

However, until further notice, HUD must be advised by DRG whenever a case is closed and the HUD Office that endorsed the case must be indicated. This will avoid any lag time in locating cases that have been closed. We intend to review each case closed in exactly the same manner that we have used to review the cases you have submitted to us thus far. We may require additional information on individual cases and expect DRG to respond promptly to those requests.

If, in the process of our monitoring, we find significant deviations from the guidance provided, or from other regulatory or handbook requirements, we will immediately begin action to withdraw your approval as a coinsuring lender and take any other appropriate action. Should this become necessary, you will receive a letter from the Assistant Secretary for Housing advising you of your termination and providing information concerning your right to a hearing.

Very sincerely yours,

Samuel R. Pierce, Jr.

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Very sincerely yours,

Samuel R. Pierce, Jr.

cc:

HMIT	Div. Chron	6142	S	Cushing	10222	HMI	Hamernick	6132
HMIT	Cheatham	6142	S	Dean	10000	HM	DeBartolomeis	6108
HMIT	Val. Files	6146	S	Eckert	10000	HPAS	Scott	9110
HMIT	MC Files	6143	ES	Goetschius	10139	UF	Walker	10126
HMII	LeClair	6140	LCR	May	10120	HPAS	Files	9126

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HMIT	HMII	HMI	HM	GP	HD
CHEATHAM	LECLAIR	HAMERNICK	DEBARTOLOMEIS	KENNEDY	WISEMAN

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HMIIBoown:6134
HMIT:CHeatham:6142

Certified Mail

Mr. John C. York, Jr.
President
York Associates
Suite 260
3201 New Mexico Avenue, NW
Washington, DC 20016

Dear Mr. York:

We are in receipt of your August 1, 1984 reply to our letter of May 16, 1984 concerning the findings made during an earlier on-site review of your 223(f) coinsurance activities. Generally, we consider the philosophical manner in which you address our concerns unsatisfactory, and that your reply offers little in the way of concrete data to lessen our concerns.

One of the major concerns born of our on-site review was the repetitive inclination of the chief underwriter to override the recommendation of appraisers and architects, nearly always resulting in higher values and rents, and lower expenses or deposits to the replacement reserve. Your reply that review and adjustment is part of the underwriter's job avoids the point. Our concern is that, when the underwriter's prerogative is used in the vast majority of the projects, questions must be raised as to the apparent suitability of the fee personnel or as to the underwriting itself.

As we pointed out in our original findings, we question many of your value determinations where the appraiser was overridden and no documentation was found in the files to support the new values.

Your letter also makes several references to the safety provided by the fact that most of your loans represent 70 percent or less of value. Our concern is that the value you reference is inflated. Therefore, a statement regarding your loan to value ratio is ~~[illegible]~~-hardly persuasive. Further, to liken Transfer of Physical Assets transactions to arms-length sales in an effort to justify value estimates is unrealistic.

We also have more general concerns. We are still awaiting a reply to our April 6, 1984 letter concerning Los Arboles Apartments and Woodside Terrace Apartments, which requested your early response. We also have not been provided with any cases in which the underwriter's prerogative was used as requested in our letter of May 16. We are concerned with some statements made in the letter accompanying your response. Page 2 indicates

HMI:10/18/84 #651361 Due: 10/26/84

CORRESPONDENCE CODE	ORIGINATOR	CONCURRENCE	CONCURRENCE	CONCURRENCE	CONCURRENCE	CONCURRENCE
	HMI1	HMI1	HMII	HMIT	HDR	HM
Name	Bowen AW Bowen	Sanders	LeClair	Cheatham	Habernick	DeBartolomeis
Date	10/24/84	10-24-84	10	10/26/84	10/31/84	[illegible]

Previous edition is obsolete
U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
HUD-713 [illegible]
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that the principals of York Associates are personally liable for losses incurred in the coinsurance program. Since we are not aware of such personal liability, we would like an explanation regarding the nature and scope of this liability. Page 3 indicates that the appraised value of Glendale Lake Apartments was $10,230,000. Documents submitted to us at endorsement indicate an appraised value of $11,105,900. This discrepancy should be reconciled.

Our detailed comments on your response are enclosed. Our original report to you presented our comments in a lettered and numbered format and the appendices to your reply generally follow that format. Therefore, the enclosure hereto presents the comments from the various reviewing disciplines in the same manner.

In sum, our grave concerns regarding the quality of your underwriting, in particular in the valuation functions, have not been assuaged by your response. Therefore, until further notice, in accordance with Chapter 2, paragraph 7 of HUD Handbook 4566.1, your authority to underwrite 223(f) coinsurance loans independent of our review is hereby suspended. Effective as of the date of receipt of this letter, ~~immediately~~, all cases for which you have not issued a firm commitment must be sent to this office for review and approval of the valuation processing prior to issuance of a commitment.

Sincerely,

Maurice L. Barksdale
Assistant Secretary

Enclosure

MAY 31 1985

Mr. John C. York, Jr.
President
York Associates, Inc.
Suite 260
3201 New Mexico Avenue NW
Washington, DC 20016-2090

Dear Mr. York:

By letter dated November 13, 1984, HUD informed you that you no longer had independent authority to issue commitments under the coinsurance program and required that future cases be reviewed by the Department prior to issuance. This requirement was imposed as a result of our review of your coinsurance operations and particularily resulted from your unsupported use of the underwriter's prerogative.

Shortly after our letter, you submitted a number of cases which you had previously closed as evidence of the adequacy of your underwriting. Twelve of these cases were given detailed review by this office. While approximately half of these cases were found to be acceptable, some of the remainder would have been found acceptable only as floor to ceiling loans, and some few were unacceptable. The specific problems with these cases were discussed with you on various occasions. The primary deficiencies centered around overaggressive rental estimates and the inappropriate inclusion in the Initial Deposit for Reserves for Replacements of funds for repairs which should have been completed prior to endorsement.

Since that time, you have submitted three cases for pre-commitment review. The cases are Marlow Plaza, Marlow Heights - Section B, and Country Estates. All three of these were reviewed by this office in detail and found acceptable, with only minor technical deficiencies which have already been transmitted to you.

Based upon the three cases submitted for pre-commitment review, we are releasing you from the requirement that HUD review each case prior to issuance of a commitment.

Until further notice, you must advise us whenever a case is closed and indicate the HUD office that endorsed the case. We will review some closed cases in the same manner that we have reviewed your prior cases to assure continued compliance with program requirements and the comments given in the past. We may require additional information on individual cases and anticipate that you will be responsive to our requests.

If, in the process of our monitoring, we find significant deviations from the guidance provided, or from other regulatory or handbook requirements, we will immediately take appropriate action.

In response to comments from you and other coinsuring lenders, we are currently taking action to revise the regulations to permit completion of repairs after endorsement in refinancing transactions as well as purchase transactions. This should relieve one of the problems you have indicated you are having in the operation of the coinsurance program. We welcome your comments on similar issues.

We look forward to a cooperative future in the coinsurance program.

Sincerely,

/S/

Janet Hale, Acting
General Deputy Assistant
Secretary

cc: HMII LeClair
HMI Hamernick
HM DeBartolomeis
H Hale
HMIT Cheatham
HPAS 9124

HMII:LECLAIR:al 5/31/85 (ext.426-7113)

	ORIGINATOR	CONCURRENCE	CONCURRENCE	CONCURRENCE	CONCURRENCE	CONCURRENCE
CORRESPONDENCE CODE	HMII:LECLAIR	HMI:BROWN	HMI:HAMERNICK	HM:DEBARTOLOMEIS		
Name						
Date	[illegible]	[illegible]	5/31/85	5/31/85		

Previous edition is obsolete

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HUD-713 (4-80)
HB 2221.1

U.S. GOVERNMENT PRINTING OFFICE: 1981-414-051

4. HUD has testified before the full Banking Committee and the Subcommittee that it lacked the "political will" to enforce the terms of its co-insurance programs. What do HUD records disclose as to the reasons for this lack of will?

We have not found any HUD records that disclose the reasons for this lack of will during the prior administration. This administration has been fully committed to enforcing program requirements. Since March 1989, nine coinsuring lenders have been suspended and thirteen have been placed on probation.

5. Has HUD or GNMA since May 1983 hired additional civil service professional (non-secretarial) staff to carry out its monitoring, enforcement, and other administrative responsibilities under the co-insurance programs and related GNMA mortgage-backed securities program? Please specify the budget year in which any person was hired and what responsibility the person was assigned.

FHA STAFF DEVOTED TO COINSURANCE PROGRAM MONITORING

Fiscal Year:	1983	1984	1985	1986	1987	1988	1989
Staff Years:							
Program:	2*	2*	2*	3*	7	8	10
Technical:	2**	2**	2**	3**	6**	6**	6**
TOTAL	4	4	4	6	13	14	16

*From 1983 through July 1986, no FHA staff were specifically assigned to coinsurance monitoring. Limited monitoring was done by Coinsurance program staff who were primarily responsible for program development and reviewing lender applications to participate in the various coinsurance programs, as that was the priority of the HUD administration during that period. The Coinsurance Monitoring Branch was established in August 1986 with an initial allocation of 6 professional staff.

**Technical Support Staff also participate in monitoring activities. Their involvement includes the review of the underwriting from architectural, cost, valuation, and mortgage credit viewpoints, which activities take place both in the field and through desk reviews of processing submitted in connection with certain waiver requests. Limited monitoring was done by this staff whose coinsurance activities also included development of underwriting instructions and review of lender applications and test cases. Although the number of Technical Support staff years spent on coinsurance monitoring has increased, there has been no increase in the number of Technical Support staff. The additional staff have been made available through a reallocation of existing staff and of priorities.

The monitoring, enforcement and administration of the GNMA Mortgage-Backed Securities program is not tailored specifically to the particular insurance programs in which the issuer participates; therefore, it is not possible to identify the number of staff years dedicated specifically to the monitoring of issuers who participate in the coinsurance program. GNMA issuers are reviewed for compliance with GNMA program requirements which are written to ensure that the GNMA investors are paid timely and that the issuer demonstrates the ability to continue to meet these obligations. The Office of Mortgage-Backed Securities has three program specialists who handle multifamily full and coinsurance MBS program compliance issues in addition to other duties. In addition, the Financial Management Division has six financial analysts who perform financial analysis on an issuer's compliance with net worth requirements and their continuing ability to meet their GNMA obligations. These analysts review issuers in all three programs: Single Family, Multifamily and Manufactured Housing.

GNMA also employs an outside contractor to perform on-site reviews of all GNMA issuers, including coinsuring lenders, for compliance with GNMA program requirements under the direction of its Office of Mortgage-Backed Securities. Up until 1989, FNMA performed these on-site reviews. In 1989, Coopers & Lybrand took over this responsibility when it was awarded this contract through a competitive bid process.

6. With respect to each co-insurer that has been terminated by GNMA as an issuer:

    (a) What ground(s) of default did GNMA rely upon in its termination/default letter?

    1. DRG Funding Corporation

       Failure to timely remit payments to holders of mortgage-backed securities

    2. Puller Mortgage Associates, Inc.

       Failure to make construction loan advances for mortgage loans backing GNMA mortgage-backed securities

    3. Southwest Funding Group

       Inability to pass-through appropriate payments of principal and interest to GNMA mortgage-backed security holders

    4. Carnegie Evans, LP

       Inability to pass-through appropriate payments of principal and interest to GNMA mortgage-backed security holders

    5. Sigma Mortgage Corporation

       Inability to pass-through appropriate payments of principal and interest to GNMA mortgage-backed security holders

    6. Brennan-Indio Incorporated

       Inability to pass-through appropriate payments of principal and interest to GNMA mortgage-backed security holders

    (b) What do GNMA records disclose as to the time period(s) that the ground(s) cited or alternative, permissible ground(s) had existed prior to the date of GNMA's default letter?

    GNMA records show that the grounds for the terminations were disclosed to GNMA no more than 1 week prior to the termination action.

(c) If GNMA records disclose that GNMA permitted forbearance from an earlier declaration of default, what do GNMA records disclose as to the reasoning for such forbearance?

GNMA records do not disclose any forbearance.

7. (a) Does HUD concur with the description of HUD's administrative failures and administrative needs (in connection with the co-insurance programs) stated in the Price Waterhouse audit of the FHA insurance funds as of fiscal years 1987 and 1988 and in the Price Waterhouse January 18, 1990, report to HUD on the co-insurance programs? If HUD does not concur in any material respect, please explain why.

HUD concurs with the Price Waterhouse findings. However, in light of HUD's intention to terminate the coinsurance program, HUD does not plan to significantly expand its capacity to monitor coinsuring lenders.

(b) Please indicate whether and to what extent HUD finds the recommendations in the January 18, 1990, report relevant to HUD's management of the full multifamily mortgage insurance program. What actions is HUD taking with respect to the full insurance programs in response to the recommendations?

The Price Waterhouse recommendations are not explicitly relevant to the multifamily full insurance program for the following reasons:

- Under full insurance, lenders do not have significant capital at risk. HUD, therefore, does not need to implement for its full insurance program the higher capital and financial reporting requirements which Price Waterhouse recommended for coinsurance.
- Under full insurance (including the contemplated delegated processing program) HUD staff (rather than private lenders) underwrite all loan commitments.

However, our experience with coinsurance and the findings of Price Waterhouse demonstrate the need to:

- Have capital requirements that are sufficient to ensure that lenders can absorb their share of losses resulting from defaults; and
- Have HUD staff more carefully screen lender applicants and more vigorously monitor program participants.

8. HUD has testified before both the full Committee and the Subcommittee that in connection with the Colonial House project in Houston, Texas, HUD was not able to prevent the funding of the original co-insured loan in the absence of fraud or material misrepresentation. At the time of HUD's consideration of its options following receipt of information from the Ft. Worth Regional Office that the project appraisal was seriously inflated, did HUD consider the effectiveness of a threat to place the co-insurer on probation or to suspend or withdraw the approval of the co-insurer? Did HUD also review the language of the co-insurer's loan commitment to determine what conditions (including, for example, the lender's being satisfied with the project's appraised value) had to be satisfied for loan funding?

In retrospect, in view of evidence which surfaced subsequent to closing, there may have been grounds for HUD to refuse to endorse the Colonial House loan because of fraud or material misrepresentation. However, at the time the loan was presented for endorsement, on the basis of information then available, HUD's General Counsel opined that HUD was bound by DRG's firm commitment.

As a direct consequence of this transaction, HUD placed DRG on probation. In effect, HUD suspended DRG's independent authority to underwrite and issue commitments and required DRG to submit all loan packages to HUD for pre-commitment review. DRG remained on probation for approximately six months. Copies of HUD's letters imposing and lifting DRG's probation are attached.

The possibility of fraud and/or material misrepresentation with respect to Colonial House and other projects with mortgages coinsured by DRG is being investigated by the FBI, as part of its ongoing criminal investigation of DRG.

LOSSES THAT HAVE BEEN -- AND ARE LIKELY TO BE -- REALIZED BY GNMA AND HUD IN THE CO-INSURANCE PROGRAMS AND RELATED MORTGAGE-BACKED SECURITIES PROGRAM, AND ACTIONS THAT GNMA AND HUD ARE TAKING -- AND CAN TAKE -- TO MITIGATE THESE LOSSES

1. The January 18, 1990, Price Waterhouse report to HUD states that HUD's recovery rate in recent asset disposals is an "absolutely dismal" 40% of the defaulted co-insured loan debt. What do HUD records disclose as to the reasons for this low recovery rate? What is HUD's average recovery rate to date for all defaulted co-insured loans that have been liquidated, if not 40%?

The recovery rate (i.e., the disposition contract sales price divided by the original coinsured loan amount) has been averaging 40%. This is attributable to a combination of the following factors:

- Improper underwriting and over-mortgaging on the original coinsured loans.
- Depressed or soft markets where many of the defaulted/disposed projects are located (e.g., Texas, Louisiana, Oklahoma, Mississippi, Georgia, Colorado, and Arizona).
- Significantly weakened investor interest in multifamily rental property, as a consequence of the Tax Reform Act of 1986.
- Decreased availability of conventional and credit-enhanced financing for multifamily rental property.

2. HUD staff have indicated to Subcommittee staff that, following GNMA's termination of DRG Funding Corp. as an issuer, GNMA and HUD staff negotiated a memorandum of understanding that addressed how the terms of the indemnification agreement between GNMA and HUD/FHA would be implemented. What were the reasons for the necessity of this formal understanding? What explains the date of the understanding relative to the September 1988 termination of DRG as an issuer? Please provide at your earliest convenience a copy of this memorandum of understanding. If similar understandings have been negotiated following the termination of other co-insurers as GNMA issuers, please provide copies of such other understandings.

On September 16, 1988, GNMA terminated DRG Funding Corporation as an issuer/servicer of GNMA mortgage-backed securities. At this time, both GNMA and FHA were presented with a brand new set of issues concerning the relationship of the two agencies and their role in the housing market. GNMA's default of DRG meant that GNMA would become the mortgagee of record responsible for the servicing of what was formally the DRG coinsured portfolio.

Discussion of the FHA and GNMA roles in servicing the portfolio commenced immediately after the default and, in February 1989, a Memorandum of Understanding (MOU) was agreed upon by FHA and GNMA. A copy of the MOU is attached. The formal agreement was necessary in order to formulate and follow a logical portfolio management plan which would be consistent with the minimal guidance provided in the regulations. The MOU was a solution to an emergency situation and was meant to be applied only to the DRG portfolio.

Andrea
4143

cc: J. Michael Dorsey
Mark Buchman
James Schoenberger
Louis Gasper
Carolyn Lieberman
Hunter Cushing
Robert Kalish
John Maxim
James Hamernick
John Ambrogne
Steven Hans/Matthew Andres
Walter Cassidy /Jerry Gross/Jim Fagerberg
Elliot Horowitz/Dick Lasner/Harold Levy
Ratner

MEMORANDUM OF UNDERSTANDING

between

ASSISTANT SECRETARY FOR HOUSING - FHA COMMISSIONER

and

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION

GNMA Management of DRG Funding Corporation's Coinsured Mortgage Portfolio

MEMORANDUM OF UNDERSTANDING

between

ASSISTANT SECRETARY FOR HOUSING - FHA COMMISSIONER

and

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION

GNMA Management of DRG Funding Corporation's Coinsured Mortgage Portfolio

On behalf of the Department of Housing and Urban Development (HUD), the Assistant Secretary for Housing - FHA Commissioner (FHA) and the Government National Mortgage Association (GNMA), a body corporate within HUD, agree as follows:

A. Background:

1. On September 16, 1988, GNMA declared DRG Funding Corporation (DRG), a major coinsurance lender-issuer, in default on its obligations under the GNMA Mortgage-Backed Securities (MBS) Program and took over DRG's portfolio of coinsured multifamily mortgages and real estate owned (REO) multifamily properties (projects acquired after borrower defaults on other such mortgages). The coinsured mortgages presently contained in the portfolio and those whose default led DRG (and later GNMA) to acquire the REO properties all were coinsured under Sections 211, 223(f) and 244 of the National Housing Act, under program regulations published at 24 CFR Part 255.

2. After defaulting DRG and demanding delivery of the coinsured portfolio, GNMA subsequently contracted with York Associates, Inc. (York), another major coinsurance lender, to manage and service the DRG portfolio for GNMA, and with Price Waterhouse to conduct portfolio-related account audits and examinations. GNMA has periodically met with FHA to discuss the status and condition of the DRG portfolio, at which times York has informally briefed GNMA and FHA concerning the portfolio. It has taken substantially longer than initially anticipated for York to acquire books, records and accounts relating to some

coinsured mortgages and REO properties in the DRG portfolio. York and GNMA are acting vigorously to acquire the remaining items.

3. York has advised that many coinsured loans are in reasonably good shape and are current, performing mortgages. Many other coinsured mortgages are in default. These non-performing mortgages include a number which York hopes to bring current through negotiated work-outs and other arrangements that are acceptable to GNMA and FHA. The remainder must be handled through foreclosure, although this may involve some bankruptcy actions. The REO projects can be sold to mitigate the coinsurance losses, prior to the submission of claims to FHA.

4. At these recent meetings between FHA and GNMA, FHA's representatives have asserted that to the maximum extent feasible it would be advantageous to HUD and FHA for GNMA to continue to manage the DRG portfolio of mortgages and REO properties on a coinsured basis. By managing the portfolio itself or through a sub-servicer, and by retaining the coinsured status of mortgages and properties in it, GNMA would relieve FHA of the need to perform loan management and property disposition functions and to incur certain administrative costs. This would take advantage of GNMA's unique and independent contracting authority under the Charter Act to contract quickly for services related tc establishing, maintaining and protecting the integrity of the MBS program. FHA does not have this special authority and would have to administer the DRG portfolio itself or arrange for such contract services under other Federal procurement procedures that are less flexible, more cumbersome, and require far more time. It is probable that the proposed arrangement would have been devised at the outset of the Coinsurance Program if the failure of such a large portfolio had been contemplated.

5. Under the arrangement FHA has proposed, so long as it is not disadvantageous to GNMA's financial interests, GNMA would manage the portfolio on a coinsured basis so as to implement a well-planned, orderly and cost-effective divestiture of all coinsured mortgages (both current, performing mortgages and those in default) and all REO properties in the portfolio. While it is difficult to predict when complete divestiture would occur, the proposed arrangement would be implemented in as short a time as prudent portfolio management and disposition warrant. FHA does not propose that GNMA retain the portfolio on a long-term basis. Unless GNMA elects to make a conversion to full insurance for any of the reasons discussed in this memorandum, during the period of this arrangement GNMA would request FHA to pay insurance benefit claims on a coinsured basis with respect to any defaulted mortgages or for any REO properties after their sale.

GNMA would retain its right under the regulations to be fully indemnified for any coinsurance payments to securities holders, as set forth particularly at 24 CFR §§255.824 and 255.828.

6. Prior to such divestiture or the termination otherwise of this arrangement, if GNMA finds that it is financially disadvantageous to continue to manage and/or service a defaulted mortgage or REO property as coinsured, then GNMA would be able to assert its current regulatory right to elect full insurance for the mortgage or property. Thereafter, GNMA's recovery of losses and other rights would be governed by the coinsurance program regulations as set forth in §§255.824 through 255.828. Moreover, GNMA would retain the regulatory right to full indemnification for any coinsurance payments by GNMA to securities holders with respect to such mortgage or property.

7. Implementation of the proposed arrangement may require GNMA to incur very high administrative costs for contractual services related to managing, servicing and disposing of the DRG portfolio's mortgages and REO properties. Therefore, in consideration for GNMA's implementing this proposed arrangement, FHA would reimburse GNMA for a share of all such administrative costs GNMA incurs under the York and other contracts, for the period beginning with the date of GNMA's sub-servicing contract with York, that are not recoverable through the claims payment process as follows:

a. FHA would periodically reimburse GNMA for 50 percent of such administrative costs incurred under the York and other contracts relating to the management, servicing and/or disposition of the DRG portfolio's defaulted/non-performing mortgages and REO properties.

b. GNMA would pay all of the remaining administrative costs under the York and other contracts, net after applying other sums recovered from DRG or other sources (including the mortgagee's portion of the appropriate mortgage insurance premiums), that mortgagees or lender-issuers typically absorb in dealing with the management, servicing and/or disposition of a portfolio of coinsured or fully insured current/performing project mortgages.

c. FHA would periodically reimburse GNMA for 50 percent of any administrative costs under the York and other contracts, other than those specified in paragraphs a and b, above, that FHA agrees are necessary and appropriate expenditures for HUD/FHA under the National Housing Act.

d. FHA would fund such reimbursements from the General Insurance Fund, as authorized by Section 1 of the National Housing Act and any other applicable law, with the procedure and details for implementing the cost-sharing arrangement to be refined and contained in a separate GNMA-FHA cost-sharing agreement that will be developed later.

e. Nothing in this agreement or in the later cost-sharing agreement will affect GNMA's right duly to procure the assistance of contractors and to manage and administer any contracts with respect to managing, servicing and/or disposing of the DRG portfolio of mortgages and REO properties.

B. Implementation of the Arrangement Is Feasible:

1. Review of the coinsurance regulations establishes that when they were published in both initial and subsequent versions the Department contemplated that most defaults by GNMA lender-issuers would place GNMA in a financially untenable position unless it could dispose of the coinsured mortgage portfolio as quickly as possible. As published, the regulations at 24 CFR Part 255 do not contemplate the proposed arrangement, but assume that any current or performing mortgages not assigned to another coinsurance lender would be designated by GNMA for full insurance as soon as possible. In large part this is because both FHA and GNMA were uncertain initially about the degree of marketplace acceptance that the multifamily coinsurance programs (refinancing, state agency and new construction) would come to enjoy. No one contemplated that so many lenders would qualify to serve as coinsurance lender-issuers, or that such a large volume of mortgages would be coinsured. It was unclear whether it would be feasible for GNMA to administer a coinsured mortgage portfolio either itself or with the aid of a sophisticated sub-servicer like York. Most importantly, it was never contemplated that so much coinsurance activity would be concentrated in a single firm that subsequently might default in its GNMA MBS obligations. Thus, the prospect of GNMA having thereafter to assign such a large volume of problem mortgages and REO properties to FHA at one time through the full insurance mechanism was considered unlikely.

2. GNMA has always insisted, and FHA has agreed, that a condition of GNMA's implementing its MBS program for FHA's multifamily coinsurance programs is that GNMA be held harmless, or indemnified, by FHA "for the amounts GNMA must pay securities holders as a result of the lender's default in payment," as set forth in §§255.824 and 255.828. Such indemnification does not include GNMA's own administrative costs. Moreover, GNMA counsel have advised that the Charter Act (Title III of the National

Housing Act) did not authorize GNMA to assume liability for, or to absorb the expenses of, the coinsurance losses that Section 244 requires a private coinsurance lender to cover when participating in the program. Although to protect itself GNMA can become a substitute coinsurance lender after declaring the lender-issuer to be in default of its MBS obligations, it must obtain full reimbursement from FHA for any coinsurance payments to securities holders. GNMA lacks the legal authority to agree to any financial arrangement with FHA concerning coinsured mortgages that does not provide for such indemnification. As mentioned above, HUD's coinsurance regulations recognize this requirement for GNMA indemnification, as set forth in and limited by §§255.224 and 255.228.

3. FHA asserts that aggregate costs to the General Insurance Fund for the DRG portfolio's management, servicing and disposition would be less for most claims submitted by GNMA under the proposed arrangement. An essential element of this cost savings is GNMA's willingness to use its unique contracting authority to arrange for the bulk of the management, servicing and disposition functions to be contracted out. In view of its staffing and procurement constraints FHA could not readily perform such portfolio management functions itself or quickly arrange for the assistance of private contractors. Because GNMA would relieve FHA of the need to administer the portfolio itself, FHA's personnel needs and other administrative costs under such an arrangement would be markedly reduced. GNMA has no basis, as yet, to disagree with this assertion, although it notes that its administrative costs of managing, servicing and disposing of the portfolio are markedly higher than originally predicted, and are likely to remain high for a longer period if the proposed arrangement is implemented. The increased administrative costs are attributed by GNMA to (a) the complexity, status and condition of the mortgages and REO properties, (b) the difficulties encountered by GNMA and York in obtaining records, documents, accounts and escrows relating to the portfolio, and (c) unusual expenses such as increased auditing and litigation costs.

4. FHA and GNMA have been advised by counsel that the coinsurance regulations do not appear either to contemplate or to prohibit the proposed arrangement for GNMA to administer the DRG coinsured portfolio. They have been advised further that so long as it is financially advantageous to FHA and not disadvantageous to GNMA this arrangement is legally permissible. There is no statutory or regulatory impediment to GNMA's acting to retain the coinsured status of the mortgages and properties in the portfolio, provided that GNMA indemnification authorized by §§255.224 and 255.228 is duly provided by FHA. Further, counsel

have agreed that where necessary the regulations can be interpreted and procedures can be fashioned to facilitate the implementation of this arrangement.

C. GNMA Treatment of DRG Portfolio Mortgages:

1. Current/Performing Mortgages: Under the arrangement GNMA is to perfect assignment of the performing mortgages to itself at this time so as to facilitate GNMA's efforts under §255.827(a)(1) to have the performing coinsured mortgages assigned to eligible coinsuring lenders. GNMA has concluded that in this case it is easier for GNMA to become owner of record so as to be able itself to further assign the mortgages to such lenders, rather than attempt to compel DRG to assign them to the lenders directly. Therefore, after perfecting the mortgage assignments to itself GNMA will have them recorded. In addition to establishing GNMA's ownership of the mortgages, recording the assignments will protect the Government's interest in each mortgage: It will serve notice to third parties that GNMA has a claim or lien against the mortgaged property, and GNMA will obtain the benefits of state recording statutes including protection against third party creditors and against fraudulent conveyances. GNMA has instructed York to develop and implement a well-planned and prudent divestiture program to sell, assign or otherwise dispose of the current/performing mortgages during the next several months. GNMA would not retain the portfolio's current mortgages indefinitely but would implement this divestiture program as quickly as is feasible.

2. Non-performing/Defaulted Mortgages: For similar reasons GNMA is also going to have the defaulted mortgages assigned to GNMA now. GNMA has to record the assignment of a defaulted mortgage in order to proceed with a foreclosure action or to accept a deed-in-lieu of foreclosure. This necessity is recognized in §255.827(b), which grants GNMA the right to perfect an assignment to itself before completing a foreclosure action or acquiring a deed-in-lieu of foreclosure. As with performing mortgages, recording the assignments will also serve to protect the Government's interest in the defaulted mortgages and covered properties. Those defaulted mortgages that can be brought current through work-outs or other negotiated arrangements acceptable to GNMA and FHA will be given maximum attention by York. After they are brought current, they will be treated as performing or current mortgages and then sold, assigned or otherwise disposed of under the planned divestiture program. For any defaulted or non-performing mortgages that cannot be brought current, GNMA has also instructed York to develop an acceptable and prudent divestiture approach under the program. GNMA does

not intend to manage or service the defaulted mortgages on a long-term basis.

3. No Election of Full Insurance at this Time: GNMA is not now perfecting the assignments of either performing or non-performing mortgages so as to exercise any regulatory right to elect their conversion at this time to fully insured mortgages. Therefore there is no need for FHA to respond to the notification contained in this agreement by changing its records now or by endorsing the mortgages for full insurance as of the date of any such assignments. FHA and GNMA have been advised by counsel that, for practical reasons, if GNMA were to elect full insurance immediately after perfecting an assignment of a mortgage to itself the regulatory phrase "date of assignment" in §255.827 can be construed to be the date GNMA causes such assignment to be recorded. But given the current circumstances, counsel have agreed that a premature application for full insurance, by formal written notice now to the Commissioner, is not necessary for GNMA's purposes and would not be to FHA's benefit. It makes no sense for FHA to endorse these mortgages for full insurance before GNMA has had an opportunity to sell the performing mortgages or foreclose on the defaulted mortgages.

4. Future Conversion to Full Insurance: FHA and GNMA assert, and their counsel have agreed, that under this arrangement any future request by GNMA to convert the performing and nonperforming mortgages now being assigned to GNMA from coinsured to fully insured status need not then be effected by FHA as of the date of these assignments. A decision to convert to full insurance might not occur for months or years. Therefore, it is appropriate and within the spirit of the published regulations to have such a conversion occur as of the date of such a future decision notice. Accordingly, if the contemplated arrangement is implemented but for policy or financial reasons GNMA later elects to have full insurance, GNMA would give notice for any such mortgage or property under §255.827(c) to the Commissioner within 30 days of the date of such a decision. Thereafter, GNMA would expect that under §255.827(d) the Commissioner then would endorse the mortgage for full insurance as of the date of such decision notice.

D. GNMA Treatment of REO Properties:

GNMA is taking all necessary and appropriate action to obtain legal title to REO property in the DRG portfolio. There are ten projects which DRG acquired through foreclosure or deed-in-lieu of foreclosure before GNMA declared DRG to be in default. York bid-in an additional project on GNMA's behalf at a foreclosure sale in November 1988. Each of the GNMA custodian pools contains a special warranty deed from DRG to GNMA. GNMA has begun the process of recording the special warranty deeds. After each special warranty deed is recorded, under the proposed arrangement GNMA will continue to deal with the REO properties as if it were the coinsuring lender, pursuant to Part 255 of the regulations. GNMA will attempt to sell the REO properties in order to mitigate the insurance loss to FHA. By following this procedure, GNMA does not waive its right to apply for coinsurance benefits on these properties. GNMA reserves its right to apply for coinsurance benefits at a later time. Naturally, as with the portfolio's mortgages, GNMA would require indemnification for any coinsurance payments to securities holders in connection with these REO properties. Moreover, GNMA further reserves its right under 24 CFR §§255.824 through 255.828 to convey any such REO property to the Commissioner that it cannot sell under its portfolio divestiture program.

E. Effective Date and Duration of Arrangement:

This agreement is effective immediately upon signature by both parties. It can be terminated by either FHA or GNMA for financial and/or policy reasons, upon 30 calendar days' written notice to the other. No termination of the agreement will prejudice GNMA's right to full indemnification of its coinsurance payments to securities holders, and/or its right to administrative cost-sharing reimbursement by FHA as set forth herein and in a subsequently executed cost-sharing agreement. This agreement will remain in effect until the earlier of (1) GNMA's completion of its planned divestiture program for all coinsured mortgages and REO properties in the DRG portfolio, or (2) the agreement's termination by either party as set forth above.

APPROVED:

2/3/89

James E. Schoenberger, General Deputy
Assistant Secretary for Housing -
Deputy FHA Commissioner

Date

Mark E. Buchman

Feb. 2, 1989

Mark E. Buchman, President
Government National Mortgage Association

Date

cc: J. Michael Dorsey, Acting Secretary and General Counsel cc (continued):

Mark Buchman
James Schoenberger
Louis Gasper
Carolyn Lieberman
Hunter Cushing
Robert Kalish
John Maxim
James Hamernick
John Ambrogne
Steven Hans/Matthew Andrea
Walter Cassidy /Jerry Gross/Jim Fagerberg
Eliot Horowitz/Dick Lasner/Harold Levy

Orig: John Maxim/JAMJR

CONCURRENCE	CONCURRENCE	CONCURRENCE	CONCURRENCE	CONCURRENCE
HMJ	HP			
Hamernick	Ambrogne			
2/2/89	2/2/89			

	ORIGINATOR	CONCURRENCE	CONCURRENCE	CONCURRENCE	CONCURRENCE	CONCURRENCE
CORRESPONDENCE CODE		GHF	GHM	HX	HM	HM
Name	Maxim	Cassidy	Horowitz	Gasper	Kalish	Cushing
Date	1/30/89	1/30/89	1/30/89	2-2-89	2-02-89	2/2/89

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3. Is the November 18, 1981, note from John Maxim to General Counsel John Knapp regarding "Coinsurance Regulations" that has been provided to Subcommittee staff the only legal memorandum prepared by HUD's Office of General Counsel that addresses the legal validity of HUD/FHA's indemnification of GNMA with respect to co-insured multifamily loans? If there are other memoranda, please provide copies at your earliest convenience.

In addition to the above memorandum addressing the legal validity of HUD/FHA's indemnification of GNMA with respect to co-insured multifamily loans, the Office of the General Counsel concurred on the regulations that provided for such indemnification.

4. (a) How many co-insured mortgage loans has GNMA presented to FHA for full insurance endorsement pursuant to HUD/FHA's indemnification of GNMA? Please identify the time period in which presentment was made.

To date, GNMA has requested that FHA endorse for full insurance a total of 67 co-insured mortgage loans. These requests have been made between August 10, 1989 and April 25, 1990, with the majority of requests coming after January 1, 1990.

(b) How many of the loans referred to in 4(a) has HUD/FHA endorsed? Please identify the time period in which endorsement occurred.

The attached charts show a schedule for completing the steps required to assign defaulted loans in GNMA's acquired portfolios to FHA.

(c) What total funds has HUD/FHA paid to GNMA to cover co-insurers' share of insurance liability on defaulted co-insured loans, pursuant to 12 C.F.R. Sections 251.824, 252.824, and 255.824 respectively? Please provide separate totals for each of the co-insurance programs and identify the time period in which payment was made.

FHA has paid to GNMA a total of $26,934,142.18 to cover the co-insurers' share of insurance liability on defaulted co-insured loans pursuant to 24 CFR 255.824. No claims have been submitted under 24 CFR 251 and 252. All claims paid have been received between October 1988 and April 1990.

(d) What total funds has HUD/FHA paid to GNMA in settlement of HUD's insurance liability to GNMA following HUD/FHA's endorsement of defaulted co-insured loans for full insurance? Please identify the time period in which payment was made.

FHA has settled one full insurance claim in the amount of $10,886,775.64. This claim was paid on December 21, 1989.

MODEL FOR DEFAULTED LOANS TO BE ASSIGNED TO FHA

STATUS REPORT AS OF 04-May-90

Project	Initial Endorsement for Coinsurance	Recordation of Assignment to GNMA	Notice to FHA of Intent to Request Full Insurance Endorsement	Note and Mortgage Submitted to FHA for Full Insurance Endorsement	Endorsement for Full Insurance	GNMA notification of Intent to Assign Mortgage	Preliminary Filing of Assignment Documents	UBL notification of Acceptance of Preliminary Documents	Recordation of Assignment to FHA	Filing of Documents with UBL and UBA	Receipt of Preliminary Payment	Receipt of Final Payment
				30 days after notice of intent to request endorsement	Within 14 days following request for endorsement	Within 45 days after FHA endorsement to full insurance		Due within 30 days of preliminary filing	Within 3 days of notification of acceptance	Within 45 days of recordation of assignment to FHA	Within 7 days after recordation date	Within 90 days after final filing
Independence Hill	6/3/86	8/3/89	7/20/89	8/10/89	11/6/89	11/15/89	12/1/89	12/8/89	12/8/89	1/23/90*	12/21/89	4/23/90*
Bonaventure	7/30/87	7/26/89	11/17/89 3/16/90	1/9/90 3/16/90	3/20/90	3/23/90						
Hilltop Gardens	10/29/85	1/12/90	1/16/90 3/19/90	1/17/90 3/19/90	4/4/90	4/5/90						
Capital Hill East (Villages at Hawthorne)	8/1/85	2/24/89	12/26/89 3/16/90	1/9/90 3/16/90	3/20/90	3/23/90						
Savannah Commons	5/22/88#	1/5/90	1/17/90 3/19/90	1/17/90 3/19/90	4/4/90	4/5/90						
Thunderbird	1/26/88#	1/5/90	1/16/90 3/19/90	1/17/90 3/19/90	4/4/90	4/5/90						
Lakeview Apartments	3/29/84	4/25/89	1/9/90 3/16/90	1/19/90 3/16/90	3/20/90	3/23/90						
Hunters Glen	10/04/85	4/14/89	1/9/90 3/16/90	1/9/90 3/16/90	3/20/90	3/23/90						
Westwood Plaza	9/19/86	3/13/89	12/26/89 3/16/90	1/9/90 3/16/90	3/20/90	3/23/90						
Raintree	8/27/86	3/1/89	1/16/90 3/16/90	1/16/90 3/16/90	3/20/90	3/23/90						
Salisbury Apartments	9/30/86	10/31/89	1/16/90 3/19/90	1/16/90 3/19/90	4/4/90	4/5/90						
One Oak Place	3/2/87	8/30/89	3/16/90	2/14/90 3/16/90	3/20/90	3/23/90	5/1/90					
East Gate	1/20/88	8/25/89	3/16/90	2/14/90 3/16/90	3/20/90	3/23/90	5/1/90					

* Target Date
# Final Endorsement

MODEL FOR DEFAULTED LOANS TO BE ASSIGNED TO FHA

STATUS REPORT AS OF 04-May-90

Project	Initial Endorsement for Coinsurance	Recordation of Assignment to GNMA	Notice to FHA of Intent to Request Full Insurance Endorsement	Note and Mortgage Submitted to FHA for Full Insurance Endorsement	Endorsement for Full Insurance	GNMA Notification of Intent to Assign Mortgage	Preliminary Filing of Assignment Documents	UGC Notification of Acceptance of Preliminary Documents	Recordation of Assignment to FHA	Filing of Documents with UGC and [illegible]	Receipt of Preliminary Payment	Receipt of Final Payment
				30 days after notice of intent to request endorsement	Within 14 days following request for endorsement	Within 45 days after FHA endorsement to full insurance		Due within 30 days of preliminary filing	Within 3 days of notification of acceptance	Within 45 days of recordation of assignment to FHA	Within 7 days after recordation date	Within 90 days after final filing
Cascade Gardens	9/30/86	2/14/89	3/1/90 3/16/90	3/1/90 3/16/90	3/20/90	3/23/90	4/19/90					
Bay Pointe (Briarwood)	11/24/86	3/10/89	3/1/90 3/16/90	3/1/90 3/16/90	3/20/90	3/23/90	4/19/90					
Asuan Villas	1/22/86	3/30/89	3/1/90 3/16/90	3/1/90 3/16/90	3/20/90	3/23/90	4/19/90					
Vadehra III	9/18/86	3/15/89	3/1/90 3/16/90	3/1/90 3/16/90	3/20/90	3/23/90						
Vadehra IV	9/18/86	11/2/89	3/1/90 3/16/90	3/1/90 3/16/90	3/20/90	3/23/90						
Monticello	10/17/85	2/15/89	3/1/90 3/16/90	3/1/90 3/16/90	3/20/90	3/23/90	4/19/90					
Park Royal	11/20/85	2/15/89	3/1/90 3/16/90	3/1/90 3/16/90	3/20/90	3/23/90	4/19/90					
Royal Palms	9/22/86	2/7/89	3/1/90 3/16/90	3/1/90 3/16/90	3/20/90	3/23/90	4/19/90					
Thunderbird Palms	1/26/87	7/12/89	2/27/90 3/16/90	3/16/90	3/20/90	3/23/90	4/19/90					
Crosswinds	9/5/85	3/2/89	3/1/90 3/16/90	3/1/90 3/16/90	3/20/90	3/23/90	4/19/90					
Lake Weston	12/30/86	3/24/89	3/1/90 3/16/90	3/1/90 3/16/90	3/20/90	3/23/90	4/19/90					

MODEL FOR DEFAULTED LOANS TO BE ASSIGNED TO FHA

STATUS REPORT AS OF 04-May-90

Project	Initial Endorsement for Coinsurance	Recordation of Assignment to GNMA	Notice to FHA of Intent to Request Full Insurance Endorsement	Note and Mortgage Submitted to FHA for Full Insurance Endorsement	Endorsement for Full Insurance	GNMA Notification of Intent to Assign Mortgage	Preliminary Filing of Assignment Documents	UGC Notification of Acceptance of Preliminary Documents	Recordation of Assignment to FHA	Filing of Documents with UGC and CFA	Receipt of Preliminary Payment	Receipt of Final Payment
				30 days after notice of intent to request endorsement	Within 14 days following request for endorsement	Within 45 days after FHA endorsement to full insurance		Due within 30 days of preliminary filing	Within 3 days of notification of acceptance	Within 45 days of recordation of assignment to FHA	Within 7 days after recordation date	Within 90 days after final filing
Briarwood Apts.	11/24/86	3/10/89	3/16/90	3/16/90	3/20/90	3/23/90	5/1/90					
The Courtyards	12/17/87	9/12/89	3/16/90	3/16/90	3/20/90	3/23/90	5/1/90					
Cimarron Apts.	7/30/87	8/29/89	3/16/90	3/16/90	3/20/90	3/23/90	5/1/90					
Park at Colonnade	3/22/88	8/25/89	3/16/90	3/16/90	3/20/90	3/23/90	5/1/90					
Highland Apts.	1/26/88	9/14/89	3/16/90	3/16/90	3/20/90	3/23/90	5/1/90					
DeVille Apartments	1/26/88	9/14/89	3/16/90	3/16/90	3/20/90	3/23/90	5/1/90					
Pebble Creek Apts.	1/21/88	8/28/89	3/16/90	3/16/90	3/20/90	3/23/90	5/1/90					
Greenbriar Apts.	1/27/88	8/28/89	3/16/90	3/16/90	3/20/90	3/23/90	5/1/90					
Chateau DeVille	3/29/88	9/14/89	3/16/90	3/16/90	3/20/90	3/23/90	5/1/90					

MODEL FOR DEFAULTED LOANS TO BE ASSIGNED TO FHA

STATUS REPORT AS OF 04-May-90

Project	Initial Endorsement for Coinsurance	Recordation of Assignment to GNMA	Notice to FHA of Intent to Request Full Insurance Endorsement	Note and Mortgage Submitted to FHA for Full Insurance Endorsement	Endorsement for Full Insurance	GNMA Notification of Intent to Assign Mortgage	Preliminary Filing of Assignment Documents	UDC notification of Acceptance of Preliminary Documents	Recordation of Assignment to FHA	Filing of Documents with UDC and UFA	Receipt of Preliminary Payment	Receipt of Final Payment
				30 days after notice of intent to request endorsement	Within 14 days following request for endorsement	Within 45 days after FHA endorsement to full insurance		Due within 30 days of preliminary filing	Within 3 days of notification of acceptance	Within 45 days of recordation of assignment to FHA	Within 7 days after recordation date	Within 90 days after final filing
120 West 105th St.	2/23/88	7/21/89	3/22/90	3/22/90	3/26/90	3/30/90						
2304 Sedgewick	11/13/87	6/29/89	3/22/90	3/22/90	3/26/90	3/30/90						
3607 Broadway	2/23/88	7/21/89	3/22/90	3/22/90	3/26/90	3/30/90						
Barclay Arms	10/30/86	9/14/89	3/22/90	3/22/90	3/26/90	3/30/90						
Camelot Apts.	6/24/87	3/14/89	3/22/90	3/22/90	3/26/90	3/30/90						
Essex St. Station	4/30/84	6/29/89	3/22/90	3/22/90	3/26/90	3/30/90						
French Village	7/17/87	9/29/89	3/22/90	3/22/90	3/26/90	3/30/90						
Glen Park	10/30/86	2/6/90	3/22/90	3/22/90	3/26/90	3/30/90						
Ironwood Apts.	10/24/86	8/30/89	3/22/90	3/22/90	3/26/90	3/30/90						
Monte Vista	6/27/86	7/12/89	3/22/90	3/22/90	3/26/90	3/30/90						
Newbern Apts.	5/9/88	2/23/89	3/22/90	3/22/90	3/26/90	3/30/90						
North Point	3/12/87	12/5/89	3/22/90	3/22/90	3/26/90	3/30/90						
Parkgate Apts.	11/20/87	9/29/89	3/22/90	3/22/90	3/26/90	3/30/90						
Pavilion Apts.	10/31/86	3/2/89	3/22/90	3/22/90	3/26/90	3/30/90						
Poplar Place	10/31/86	8/3/89	3/22/90	3/22/90	3/26/90	3/30/90						
San Pablo Apts.	11/2/87	8/29/89	3/22/90	3/22/90	3/26/90	3/30/90						
San Raphael	1/17/85	3/3/89	3/22/90	3/22/90	3/26/90	3/30/90						
Stratford Woods	11/30/84	9/29/89	3/22/90	3/22/90	3/26/90	3/30/90						
Ventura Apts.	6/30/87	3/1/89	3/22/90	3/22/90	3/26/90	3/30/90						
Village Square	8/30/85	11/17/89	3/22/90	3/22/90	3/26/90	3/30/90						

MODEL FOR DEFAULTED LOANS TO BE ASSIGNED TO FHA

STATUS REPORT AS OF 04-May-90

Project	Initial Endorsement for Coinsurance	Recordation of Assignment to GNMA	Notice to FHA of Intent to Request Full Insurance Endorsement	Note and Mortgage Submitted to FHA for Full Insurance Endorsement	Endorsement for Full Insurance	GNMA Notification of Intent to Assign Mortgage	Preliminary Filing of Assignment Documents	OGC notification of Acceptance of Preliminary Documents	Recordation of Assignment to FHA	Filing of Documents with OGC and OFA	Receipt of Preliminary Payment	Receipt of Final Payment
				30 days after notice of intent to request endorsement	Within 14 days following request for endorsement	Within 45 days after FHA endorsement to full insurance		Due within 30 days of preliminary filing	Within 3 days of notification of acceptance	Within 45 days of recordation of assignment to FHA	Within 7 days after recordation date	Within 90 days after final filing
Sun City Apts.	12/31/86	5/3/89	4/20/90	4/20/90								
Birchwood Apts.	4/26/86	7/5/89	4/20/90	4/20/90								
Arrowood Townhouses	6/26/87	3/16/90	4/20/90	4/20/90								
Sturbridge Square	8/27/86	2/22/90	4/20/90	4/20/90								
Strawberry Fields	9/30/86	3/23/90	4/20/90	4/20/90								
Williamsburg Village Apts.	9/29/86	4/12/90	4/20/90	4/20/90								
View Point Apts.	9/26/89	2/9/90	4/25/90	4/25/90								
Autumn Chase	12/16/86	3/22/90	4/25/90	4/25/90								
Briargate II	9/14/86	3/23/90	4/25/90	4/25/90								
Coventry Apts.	9/14/88	3/23/90	4/25/90	4/25/90								
Woods Apartments	9/14/86	3/23/90	4/25/90	4/25/90								
Compass Pointe	11/14/88	3/14/90	4/25/90	4/25/90								
Carriage House	11/14/86	3/14/90	4/25/90	4/25/90								
Deerfield Apts.	10/26/86	3/12/90	4/25/90	4/25/90								

5. HUD staff have indicated to Subcommittee staff that, when GNMA steps into the shoes of a defaulted issuer, HUD/FHA loses the ability to refuse insurance payments by reason of the fraud or material misrepresentation of the issuer/co-insurer. In effect, GNMA is protected against an issuer's fraud or material misrepresentation vis-a-vis HUD/FHA once GNMA defaults an issuer and takes over the issuer responsibility. Is this an accurate statement? If not, please indicate how and when HUD/FHA loses the defenses of fraud and material misrepresentation, when GNMA is the claimant for insurance benefits. Please also provide copies of opinions of HUD's Office of General Counsel relevant to this matter at your earliest convenience.

Historically, FHA has taken the position that, for a mortgage held by an assignee lender, it may declare the contract of mortgage insurance void only if the assignee lender knew of fraud or mispresentation of the originating lender at the time the fraud took place or at the time it acquired the mortgage. In that GNMA did not participate in and had no knowledge of any fraud or mispresentation with regard to the defaulted coinsurance portfolios, under FHA's criteria, the insurance is incontestable.

6. Has any GNMA-guaranteed, mortgage-backed security issued by any co-insurer and backed by a co-insured loan in default been prepaid in advance of its original maturity? If your answer is in the affirmative, please identify the issuers involved and the aggregate amount prepaid with respect to each issuer.

Although it is known that defaulted coinsured loans have caused the prepayment of mortgage-backed securities prior to their original maturity date, GNMA does not track that information. Terminations of a pool are recorded but the reason for termination is not noted.

7. In its written testimony at the March 27th Subcommittee hearing HUD stated that the volume of defaulted co-insured loans had increased to more than $1.6 billion, and $883 million of that total is included in the loan portfolios of co-insurers that GNMA has terminated as issuers. Please provide a break-down of the $1.6 billion figure by co-insurer and co-insurance program. HUD describes the default rate as "skyrocketing". What do HUD records disclose as to the reasons for the "skyrocketing" increase in loan defaults?

Attached are copies of the tables, dated March 21, 1990, which formed the basis for the coinsured default information in Under Secretary DelliBovi's written testimony for the March 27, 1990 Subcommittee hearing. These tables provide a breakdown of defaults by program and lender and are based on electromagnetic data provided to HUD by coinsuring lenders. Also attached are the most recent editions of these tables, dated May 9, 1990, showing defaults as of May 1, 1990.

Also attached are copies of charts showing default trends since May 1989, when Secretary Kemp ordered a comprehensive evaluation of multifamily coinsurance and imposed a moratorium on new entrants into the program. During this one-year period, the dollar amount of coinsured loans in default increased from $914,068,400 to $1,635,774,000, an increase of 79%!

The increase in defaults is attributable to a combination of the following factors:

- Improper underwriting and over-mortgaging.
- Depressed or soft markets.
- Inadequate market demand for retirement service centers (ReSCs).
- Dumping of projects by owners who previously "cashed out".
- Weakened investor interest in multifamily rental property, as a consequence of the Tax Reform Act of 1986. (This is manifested by limited partners no longer willing to "ante up" to cover operating deficits.)
- "Drying up" of sources of capital and credit for companies that invest in real estate.

DELINQUENCY through CLAIM NOTIFICATION SYSTEM (DCNSII)

COMPARISON of 223(f) Projects in DEFAULT with Mortgages in Force as of 03/01/90

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MORTGAGEE		COINSURED MORTGAGES IN FORCE			ORIGINAL MORTGAGE VALUE			ADVANCES	
		TOTAL	DEFAULTS	% IN DEFAULT	TOTAL	DEFAULT	% IN DEFAULT	CURRENT MONTH	TOTAL
American Mortgages, Inc.		49	2	4.08 %	283,811,600	5,057,500	1.78 %	60,858	333,847
Benton Mortgage Company		101	4	3.96 %	373,440,300	13,567,000	3.63 %	351,680	1,318,973
Brennan-Indio, Inc.		26	1	3.85 %	124,202,000	6,314,100	5.08 %	55,492	109,017
Carnegie Evans L.P.		10	2	20.00 %	83,437,700	11,933,100	14.30 %	128,280	503,192
DRG Funding Corp. (Serviced by Reilly Mtg. Co.)		79	8	10.13 %	586,795,700	64,490,800	10.99 %	279,965	279,965
DRG Funding Corporation (Serviced by YORK ASSOC.)		204	113	55.39 %	998,098,700	714,006,500	71.54 %	5,530,353	76,479,087
Davis-Penn Mortgage Company		14	2	14.29 %	28,668,200	4,256,000	14.85 %	0	366,334
Merchants Mortgage Corporation		6	1	16.67 %	20,086,300	2,380,000	11.85 %	0	0
Sigma Mortgage Corporation (Formerly Eagle Mtg.)		26	18	69.23 %	107,338,000	80,595.000	75.09 %	529,924	1,718,388
Southwest Funding Group, Inc.		41	17	41.46 %	136,290,400	59,705,000	43.81 %	333,105	3,166,870
York Associates		345	56	16.23 %	2,282,541,200	300,278,400	13.16 %	584,198	4,305,637
Other Lenders		170	0	00.00 %	1,325,125,475	0	00.00 %	0	0
		=======	===	=====	=============	===========	=====	===========	=============
T O T A L S :		1,079	224	20.76 %	6,349,035,575	1,262,583,400	19.88 %	7,851,853	88,582,018
Last Month	02/90	1,074	210	19.55 %	6,333,804,075	1,192,733,400	18.83 %	8,022,358	82,349,758
Six Months Ago	09/89	1,047	146	13.94 %	6,177,483,575	855,777,100	13.85 %	5,910,598	55,533,832
One Year Ago	03/89	975	150	15.38 %	5,733,099,000	886,741,850	15.47 %	8,304,000	30,179,587

DELINQUENCY through CLAIM NOTIFICATION SYSTEM (DCNSII)

COMPARISON of 221(d) Projects in DEFAULT with Mortgages in Force as of 03/01/90

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	COINSURED MORTGAGES IN FORCE			ORIGINAL MORTGAGE VALUE			ADVANCES	
MORTGAGEE	TOTAL	DEFAULTS	% IN DEFAULT	TOTAL	DEFAULT	% IN DEFAULT	CURRENT MONTH	TOTAL
ABG Financial Services, Inc.	41	2	4.88 %	395,730,000	36,920,000	9.33 %	0	1,281,104
Boston Mortgage Company	45	1	2.22 %	262,613,200	9,856,200	3.75 %	107,307	1,004,317
Carnegie Evans L.P.	20	4	20.00 %	169,416,900	31,722,100	18.72 %	394,338	893,282
Cincinnati Mortgage Corporation	13	1	7.69 %	119,259,000	6,283,000	5.27 %	50,096	50,096
Meritor Mortgage Corporation-Central	7	2	28.57 %	62,821,000	9,991,400	15.90 %	549,552	559,259
Patrician Mortgage Company	33	2	6.06 %	333,894,500	12,863,900	3.85 %	109,608	183,615
Puller Mtg. (Serviced by American Cap. Resources)	21	7	33.33 %	296,494,000	117,159,300	39.52 %	0	3,903
Puller Mtg. (Serviced by Coopers & Lybrand)	13	8	61.54 %	175,712,000	124,880,300	71.07 %	176,381	2,104,990
Other Lenders	77	0	00.00 %	829,327,100	0	00.00 %	0	0
T O T A L S :	270	27	10.00 %	2,645,195,700	349,683,000	13.22 %	1,340,219	6,123,396
Last Month 02/90	263	24	9.13 %	2,564,717,000	332,399,400	12.96 %	1,562,021	5,107,409
Six Months Ago 09/89	242	11	4.55 %	2,343,452,000	117,612,000	5.02 %	391,218	2,888,411
One Year Ago 03/89	213	8	3.76 %	2,071,591,000	82,339,400	3.97 %	681,000	1,720,940

DELINQUENCY through CLAIM NOTIFICATION SYSTEM (DCNSII)

COMPARISON of 223(f) Projects in DEFAULT with Mortgages in Force as of 05/01/90

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MORTGAGEE		COINSURED MORTGAGES IN FORCE			ORIGINAL MORTGAGE VALUE			ADVANCES	
		TOTAL	DEFAULTS	% IN DEFAULT	TOTAL	DEFAULT	% IN DEFAULT	CURRENT MONTH	TOTAL
American Mortgages, Inc.		51	2	3.92 %	304,309,500	5,057,500	1.66 %	50,907	445,201
Benton Mortgage Company		101	5	4.95 %	373,440,300	17,277,000	4.63 %	303,974	1,077,700
Brennan-Indio, Inc.		27	2	7.41 %	128,357,000	13,184,500	10.27 %	104,390	301,187
Carnegie Evans L.P.		10	9	90.00 %	83,437,700	82,134,200	98.44 %	832,760	1,262,885
DRG Funding Corp. (Serviced by Reilly Mtg. Co.)		79	3	3.80 %	586,795,700	26,255,700	4.47 %	40,032	40,032
DRG Funding Corporation (Serviced by YORK ASSOC.)		183	116	63.39 %	858,153,400	743,310,300	86.62 %	5,239,763	73,088,481
Devon-Penn Mortgage Company		13	1	7.69 %	27,107,200	1,561,000	5.76 %	14,019	309,160
Merchants Mortgage Corporation		6	2	33.33 %	20,086,300	4,480,000	22.30 %	0	0
Sigma Mortgage Corporation (Formerly Eagle Mtg.)		28	9	32.14 %	111,555,000	39,893,000	35.76 %	307,100	2,370,646
Southwest Funding Group, Inc.		41	17	41.46 %	138,290,400	56,824,200	41.09 %	424,132	4,074,669
TMI Capital Corporation		23	1	4.35 %	78,654,600	2,077,900	2.64 %	10,261	94,321
York Associates		325	52	16.00 %	2,140,484,000	261,123,400	12.20 %	549,470	4,370,277
Other Lenders		166	0	00.00 %	1,302,062,475	0	00.00 %	0	0
T O T A L S :		1,053	219	20.80 %	6,150,736,175	1,253,170,700	20.37 %	7,777,194	90,838,477
Last Month	04/90	1,079	216	20.02 %	6,349,035,975	1,245,150,000	19.61 %	7,734,038	95,300,422
Six Months Ago	11/89	1,056	168	15.91 %	6,224,206,075	972,275,900	15.62 %	7,537,039	68,098,487
One Year Ago	05/89	990	139	14.04 %	5,809,357,800	807,715,000	13.90 %	5,082,086	37,307,434

DELINQUENCY through CLAIM NOTIFICATION SYSTEM (DCNSII)

COMPARISON of 221(d) Projects in DEFAULT with Mortgages in Force as of 05/01/90

C O N F I D E N T I A L !!

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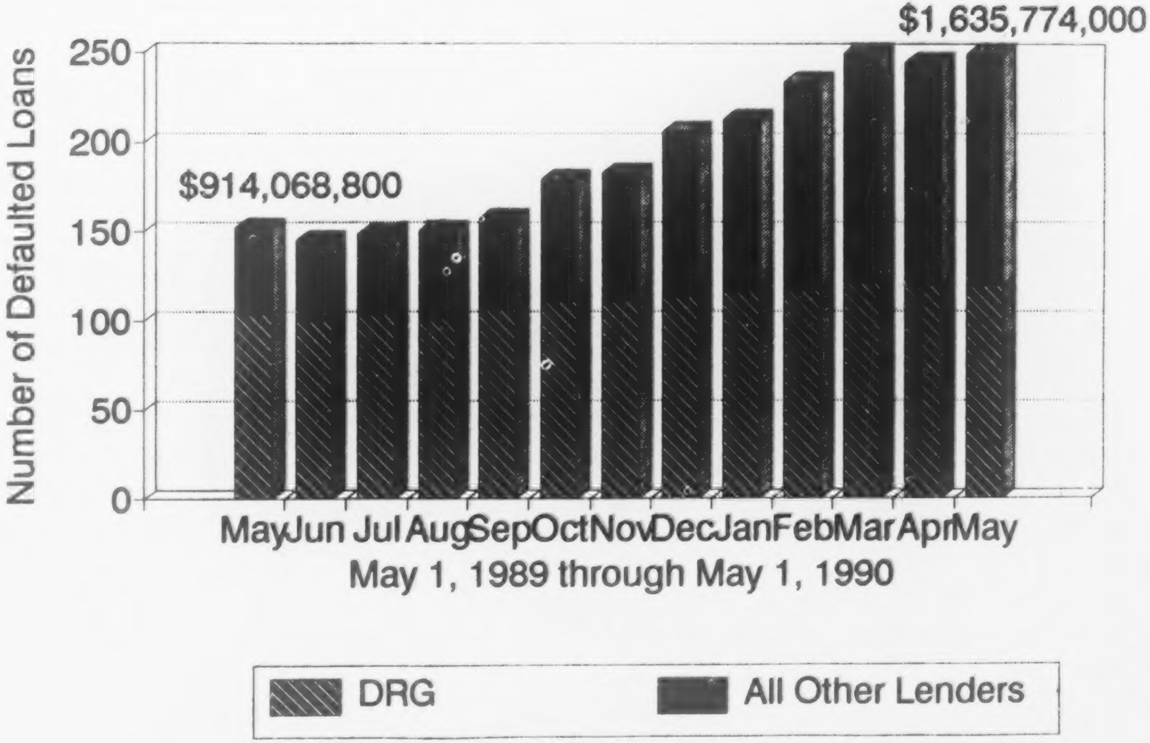
	OUTSTANDING MORTGAGES IN FORCE			ORIGINAL MORTGAGE VALUE			ADVANCES	
MORTGAGEE	TOTAL	DEFAULTED	% IN DEFAULT	TOTAL	DEFAULT	% IN DEFAULT	CURRENT MONTH	TOTAL
ABC Financial Services, Inc.	42	3	7.14 %	400,210,000	52,882,900	13.21 %	60,003	1,330,571
Boston Mortgage Company	45	1	2.22 %	262,613,200	9,856,200	3.75 %	167,307	1,330,091
Carnegie Evans L.P.	20	4	20.00 %	169,416,900	31,722,100	18.72 %	208,913	1,497,913
Cincinnati Mortgage Corporation	13	1	7.69 %	119,259,000	6,283,000	5.27 %	28,320	109,095
N-West Mortgage Corporation (formerly Meritor)	7	2	28.57 %	62,831,000	9,991,400	15.90 %	690,918	718,988
Patrician Mortgage Company	33	4	12.12 %	333,854,500	17,439,200	5.22 %	84,000	313,209
Puller Mtg. (Serviced by American Cap. Resources)	21	7	33.33 %	296,454,000	124,628,600	42.04 %	0	9,902
Puller Mtg. (Serviced by Coopers & Lybrand)	13	8	61.54 %	175,712,000	129,797,900	73.87 %	439,864	1,532,196
Other Lenders	81	0	00.00 %	870,492,100	0	00.00 %	0	0
T O T A L S :	275	30	10.91 %	2,690,800,700	382,595,300	14.10 %	1,709,910	6,093,985
Last Month 04/90	270	29	10.74 %	2,645,195,700	368,220,500	13.92 %	1,998,700	5,930,180
Six Months Ago 11/89	246	15	6.10 %	2,373,072,200	187,313,300	7.89 %	401,177	3,239,767
One Year Ago 05/89	219	13	5.94 %	2,144,771,700	106,353,000	4.96 %	914,398	3,151,398

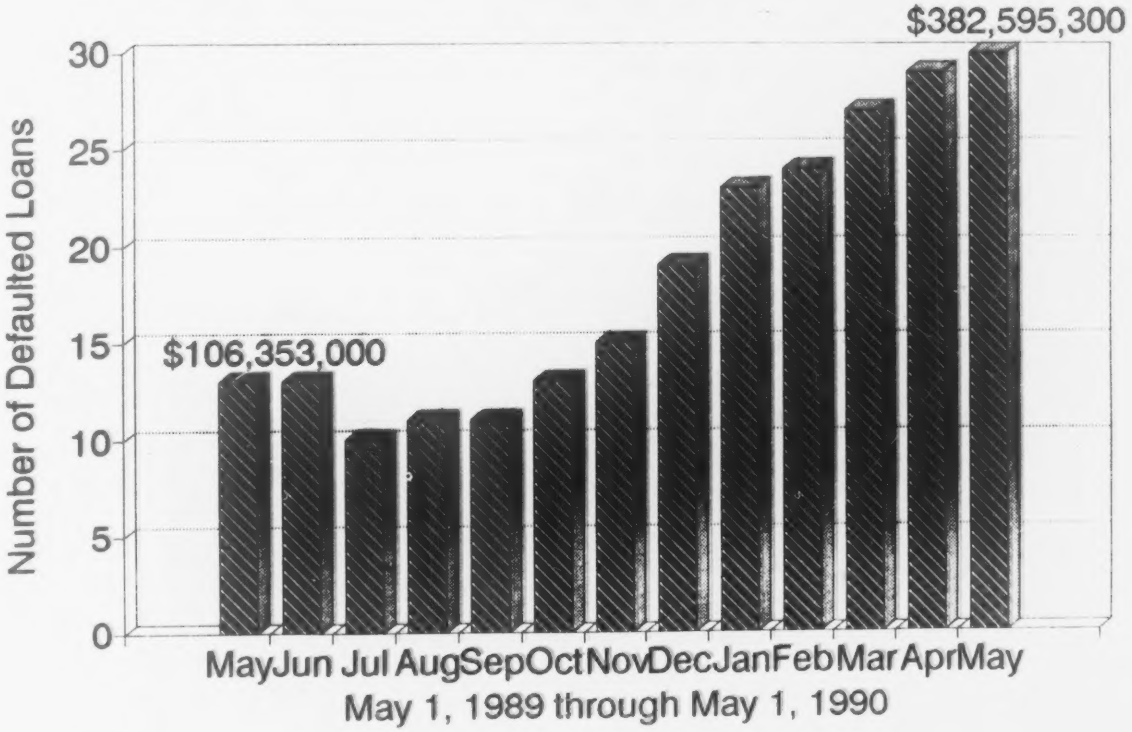
Defaulted Coinsured Loans

Since Moratorium Began in May 1989

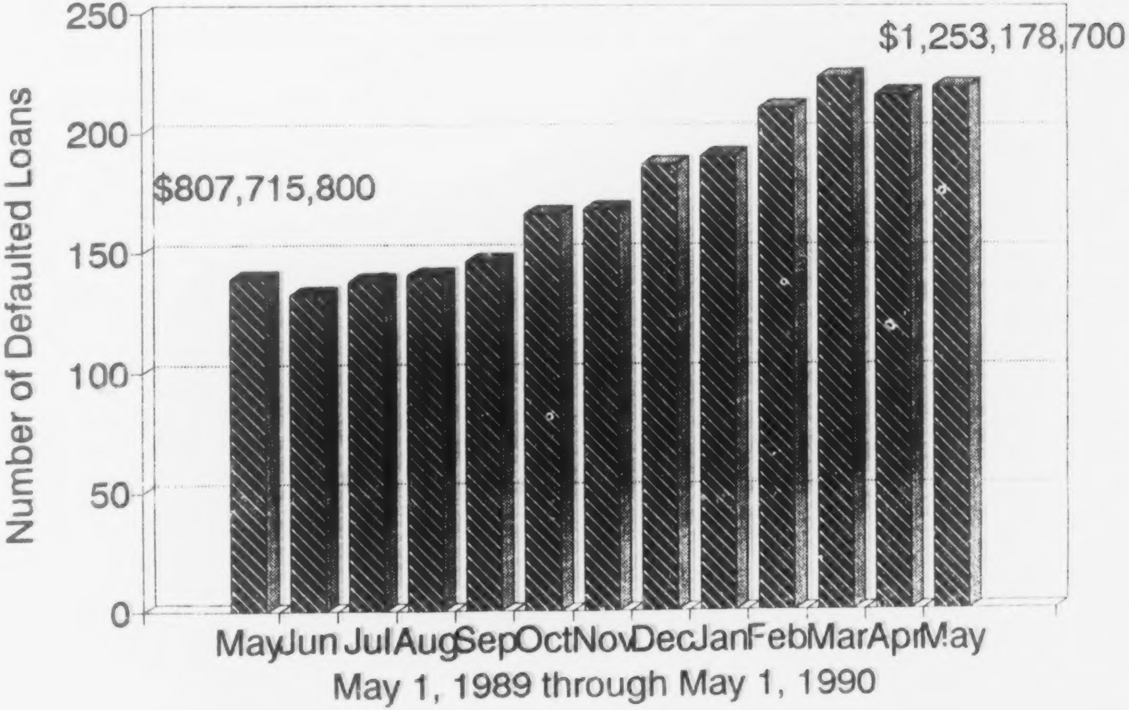


Defaulted 221(d) Loans

Since Moratorium Began in May 1989



Defaulted 223(f) Loans
Since Moratorium Began in May 1989



8. With respect to the co-insured loans that have defaulted to date:

(a) What number of loans have defaulted?

There are currently 249 coinsured loans in default. This number does not include the 35 coinsured projects for which claims have been paid. Thus, the cumulative total of defaulted projects is 284.

(b) What number of the loans became the subject of workout negotiations?

This information is not readily available. We estimate that fewer than 20 percent of defaulted mortgagors have engaged in serious workout discussions with their coinsuring lenders.

(c) Of the number identified in 8(b) what number resulted in a workout that returned the loan to paying status?

This information is also not readily available. GNMA has negotiated "refunders" for six projects financed with tax-exempt bonds. These refunders have reinstated mortgages totalling approximately $70 million.

9. **What actions, if any, have GNMA and HUD identified that each could take--but has not yet taken-- that would mitigate the losses (or increase the recovery rate) that GNMA and HUD are experiencing with respect to defaulted co-insured loans? If there are actions that have been identified, why haven't GNMA and HUD taken such actions earlier?**

(a) GNMA Actions

Due to the mandatory cash pass-throughs to GNMA security holders, there are few options available to GNMA when it has a portfolio of defaulted loans. GNMA feels it made a major contribution in its portfolio management by identifying potential Bond Refunders and bringing $70 million mortgages current through that program.

GNMA also worked aggressively with owners and managers of defaulted loans to encourage them to bring the loans current either by owner contributions or sales of the projects to other owners.

GNMA knows of no actions which it could have taken that it did not.

(b) FHA Actions

FHA has always encouraged coinsuring lenders and defaulted mortgagors to negotiate workouts and refunders. FHA also encourages Transfers of Physical Assets (TPAs) to bring in new owners, capital and management. However, since virtually all coinsured mortgages have been financed with GNMA mortgage-backed securities, coinsuring lenders, like GNMA, are limited in the types of mortgage relief they can offer.

Some coinsuring lenders have proposed that HUD provide "operating loss loans" and "partial payment of claims", but to date no viable program options have emerged.

10. (a) What civil claims has GNMA initiated against co-insurers for recoupment of monies that GNMA has expended as guarantor of securities backed by co-insured loans and does not expect to recoup from HUD/FHA? What is GNMA's success in recovering on such claims?

Under the regulations found at 251, 252, and 255.826 HUD's recourse against a defaulted lender/issuer is delegated primarily to the FHA Commissioner. (See 10(b).)

Currently, there are several criminal investigations underway related to the activities of defaulted coinsuring lenders/issuers. In addition, HUD's Offices of the Inspector General and the General Counsel are working with GNMA on the possible initiation of civil claims against defaulted issuers. GNMA is coordinating the above actions with the U.S. Attorney's Office, and will most likely defer civil claims until the criminal investigations are completed and GNMA tallies its losses not recouped from FHA.

(b) What civil claims has HUD/FHA initiated against co-insurers for recoupment of monies that HUD/FHA has expended to indemnify GNMA against loss on co-insured loans? What is HUD/FHA's success in recovering on such claims? Is HUD/FHA able to use such claims as an offset against a co-insurer's insurance claim against HUD? To what extent has HUD exercised any such right of offset?

As of May 15, 1990, FHA had not initiated any civil claims against coinsurers for recoupment of monies that FHA has expended to indemnify GNMA against losses on defaulted coinsured loans. FHA has only recently begun paying indemnification claims to GNMA. Prior to April 1990, FHA had only paid coinsurance benefits to GNMA (i.e., the same benefits FHA would have paid the coinsuring lender, had it not defaulted). Since April 23, 1990, FHA has paid GNMA 12 indemnification claims totalling $26,934,142.18. FHA intends to assert civil claims against DRG for recoupment of this amount as well as the amounts of any future indemnification claims. FHA also may use these amounts to offset any claims that DRG may assert against HUD.

11. How many dwelling units that were financed or refinanced with the benefit of the co-insurance programs have been sold at or following foreclosure sale to purchasers, who have rented--or expect to rent--the units in the conventional (unassisted) market? Please provide a break-down of these units by co-insurance program.

As of May 15, 1990, 45 projects with defaulted coinsured loans had been acquired and sold. These projects contain 11,574 units. All projects sold to date originally had mortgages coinsured under the Section 223(f) coinsurance program. Since none of these projects had project-based subsidies when they were acquired and since no Section 8 assistance was provided when the projects were sold, it is reasonable to assume that the purchasers have rented or expect to rent the units in the conventional (unassisted) market.

12. How does the mortgage insurance premium income that HUD has received with respect to co-insured loans compare with the losses that HUD/FHA has realized to date under the co-insurance programs? Please provide a break-down of this comparison by co-insurance program? If HUD is able to provide this comparison as of a future date as well, please do so.

We estimate that HUD's mortgage insurance premium income on coinsured loans to date totals approximately $186 million. (The methodology for this estimate is attached.) To date, HUD has paid coinsurance claims totalling $149 million. However, on an accrual basis, FHA's losses have been significantly greater. The General Accounting Office, in its audit of the 1988 FHA Financial Statements, estimated total losses of $960 million on coinsured loans that had closed through the end of FY 1988, with future losses likely. On the basis of the GAO 1988 figure, FHA's coinsurance losses have exceeded its coinsurance income by 416%!

Rough Estimate of Potential MIP Paid to HUD to Date on all Coinsured Loans

223(f) Program

[A]	Loan Totals [B]	Initial MIP [C] (B X .65%)	Annual to Current [D] (B X .4% X 1990 - A)	Initial + Annual (C + D)
1983	$226,688,100	$1,473,472.65	$6,347,266.80	$7,820,739.45
1984	$537,281,300	$3,492,328.45	$12,894,751.20	$16,387,079.65
1985	$728,000,500	$4,732,003.25	$14,560,010.00	$19,292,013.25
1986	$1,670,953,900	$10,861,200.35	$26,735,262.40	$37,596,462.75
1987	$1,974,126,100	$12,831,819.65	$23,689,513.20	$36,521,332.85
1988	$1,436,330,375	$9,336,147.44	$11,490,643.00	$20,826,790.44
1989	$799,437,700	$5,196,345.05	$3,197,750.80	$8,394,095.85
1990	$49,862,000	$324,103.00	$0.00	$324,103.00
			Potential TOTAL MIP Paid:	$147,162,617.24

221(d) Program

[A]	Loan Totals [B]	Initial MIP [C] (B X .65%)	Annual to Current [D] (B X .4% X 1990 - A)	Initial + Annual (C + D)
1986	$317,297,200	$2,062,431.80	$5,076,755.20	$7,139,187.00
1987	$836,667,000	$5,438,335.50	$10,040,004.00	$15,478,339.50
1988	$599,684,000	$3,897,946.00	$4,797,472.00	$8,695,418.00
1989	$626,793,800	$4,074,159.70	$2,507,175.20	$6,581,334.90
1990	$135,121,800	$878,291.70	$0.00	$878,291.70
			Potential TOTAL MIP Paid:	$38,772,571.10

Total for Both Programs: $185,935,188.34

13. How does the guarantee fee income that GNMA has received with respect to guaranteed securities backed by co-insured loans compare with the losses that GNMA has realized to date with respect to such loans (and does not expect to recoup from co-insurers or HUD/FHA)? Please provide a break-down of this comparison by co-insurance program. If GNMA is able to provide this comparison as of a future date as well, please do so. Please also identify the losses that GNMA expects to recoup from co-insurers or HUD/FHA.

GNMA did not break down and separately track guarantee fee income between the full insurance program and coinsurance program until 1989. Therefore, data is not currently available to respond to this question. Except for certain legal, accounting and administrative costs incurred in taking over and servicing the portfolios of defaulted coinsuring lender/issuers, GNMA expects to recover its losses on all defaulted coinsured loans from FHA.

14. What is HUD's current estimate of the Section 8 rent subsidy and other financial assistance that it may be obligated to provide, pursuant to Section 203 of the Housing and Community Development Act of 1978, as amended, following GNMA's assignment of defaulted co-insured loans that have been endorsed for full insurance? What actions do GNMA and HUD intend to take to reduce the likelihood of incurring these costs?

Section 203, as currently written, requires HUD to provide, in conjunction with the acquisition and sale of defaulted projects, Section 8 assistance for all units that are either vacant or occupied by income-eligible tenants.

GNMA is in the process of assigning 79 defaulted coinsured loans and conveying 34 REO projects to FHA. These 113 projects contain approximately 28,000 units, of which approximately 7,000 are vacant. Of the 21,000 occupied units, we estimate that one-third (7,000 units) are occupied by income-eligible tenants.

Unless Section 203 is amended, we estimate that HUD would be obligated to provide Section 8 assistance to approximately 14,000 units -- half of the units in the defaulted projects identified above. Since Property Disposition Section 8 assistance averages $6,000 per year, the additional annual Section 8 obligation (contract authority) would be $84 million. This translates to $1.26 billion over the 15 years of the HAP Contracts, and the need for close to $1.3 billion in additional budget authority. In current dollars, this would add approximately $400 to $500 million to the Federal disposition costs.

To avoid incurring such costs for these projects and other similar projects to be acquired and sold in the future, HUD has proposed legislation to amend Section 203 so that it would not apply to unsubsidized projects.

OTHER

1. Please provide the most current inventory feasible of property that HUD owns or holds as mortgagee in possession (or equivalent such as deed of trust trustee) in the State of Florida that is either "eligible multifamily housing property" or "eligible single family property" as those terms are used in Section 21A(c)(9) of the Federal Home Loan Bank Act, as amended by Public Law 101-73, dated August 9, 1989. Please provide a break-down of this inventory by type (multifamily or single family) and by county.

FIRREA, the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (P.L. 101-73) defines "eligible multifamily housing property" and "eligible single family property", in part, as property "to which the Corporation [Resolution Trust Corporation] acquires title". Since the RTC is not taking title to any properties that HUD owns or holds as mortgagee in possession, there are no HUD properties in Florida or elsewhere that meet the "eligible properties" definition.

2. As you offered at the hearing, please submit for the record your explanation of the discretion (that was normally exercised by the HUD Field Office in full insurance cases) that co-insurers exercised in determining the Section 8 rent level for a project that was financed with both a co-insured multifamily mortgage and Section 8 moderate rehabilitation rent subsidies.

The following points illustrate how the coinsurance and Section 8 Moderate Rehabilitation (Mod Rehab) programs were used in conjunction.

- Under the Mod Rehab program, Public Housing Authorities (PHAs) were required to establish rents for units to be assisted based on the costs of amortizing the loan for the rehabilitation work added to the basic costs of owning, operating and managing the property.
- When financing was through coinsurance, the coinsuring lender established mortgage insurance processing rents, which are required to be the lesser of market comparable rents or the Section 8 Mod Rehab Fair Market Rent limitations.
- Some coinsuring lenders--and some HUD field offices--may have incorrectly interpreted the procedures covering HUD fully insured Mod Rehab projects as being applicable to the co-insurance program; accordingly, these lenders set the rents themselves, as putative agents of HUD. On the other hand, except in isolated cases, HUD did not change its instructions that PHAs were to carry out the PHA responsibilities for setting Mod Rehab Section 8 contract rents.
- Audits of coinsured lender activities in the Mod Rehab program have indicated that Mod Rehab rents established during this period by such lenders were excessive for the following reasons: (i) rehabilitation work which would have been ineligible in the Mod Rehab program was included in the mortgage and rent calculations; and (ii) inflated "comparables" were used -- also contributing to higher mortgage amounts and excessive Section 8 rents. In 10 projects audited, the OIG estimated that millions in excess Section 8 subsidies would be paid out over the 15-year life of the HAP contracts.

- In January 1988, HUD issued explicit clarifying instructions: Mod Rehab Section 8 contract rents in coinsured cases were to be the lower of the PHA's cost-based rent calculations or the comparable rents established by the coinsuring lender. Subsequently, in May 1989, the insured processing procedures were made applicable to coinsured Moderate Rehabilitation projects but with the HUD field office, not the coinsuring lender, being responsible for setting the Section 8 contract rents.

Mr. MONROE. One of the problems is that in section 8 the rents would be set contractually but only for 15 years, whereas the life of the mortgage was substantially longer. That's why we couldn't really underwrite based on the section 8 rents. We really were required to determine what the market rents were because once that section 8 subsidy went away you wanted to be sure that you had loan amount that could be supported by the market without the section 8.

Senator GRAHAM. The question is, who was given the authority of making that judgment?

Mr. DELLIBOVI. Senator, we will check into that and get the exact answer, but I believe what we will find is that it wasn't so much the authority to set the rent was delegated as that the authority to estimate what the set rent was going to be, to predict the rent——

Senator GRAHAM. Well, we heard testimony that, if the coinsurer said the fair market rent is $500, that that then went to whoever made the section 8 determination as almost biblical and that that number was then accepted as the section 8 level of rents.

Mr. MONROE. It wasn't delegated to coinsuring lenders. The actual responsibility for determining the section 8 contract rents was in the public housing authority. Recently HUD has pulled back that delegation and now takes responsibility for reviewing those contract rents. It never was formally delegated.

Senator GRAHAM. Mr. Dale.

Mr. DALE. I'd like to go back to the concept that we were discussing a few moments ago about risk-sharing because I see that as an important concept not just in multifamily lending but in all real estate lending and I think we are seeing it increasingly used and increasingly viable and the question is, how do you carve up and manage those risks between owners, primary lenders, mortgage insurers, the secondary market, investors and the Government?

It seems to me that that is a concept that is one that needs to be a part of our real estate lending system and, indeed, certain aspects of processing and underwriting can be delegated. They cannot, as we've clearly learned, be abdicated. I think that was maybe a key distinction that was made earlier.

Fannie Mae has a lot of experience in both single and multifamily programs in risk-sharing types of arrangements and by and large that experience has been excellent. Specifically, we operate a multifamily lending program that, at least at the concept level of sharing risks with a primary origination system of lenders is analogous or similar to coinsurance. Once you leave the concept, virtually every detail in terms of program administration, structure and monitoring an ongoing administration and management is radically different and I think in those differences lies in some degree the difference between the success we've enjoyed with that program, which enjoys a very low default rate at the moment, although it's a young program so we don't have a long track record of seasoning, but at the moment our default rate is less than one percent and the coinsurance experience which has obviously been radically different.

I mentioned a few of those but I would like to spend just a minute going into a little bit more detail.

First of all, the rigor with which we deal with lenders is much more severe than the rigor that HUD dealt with coinsuring lenders. The capital requirements are higher. They are monitored for their capital much more frequently. We keep very close track of capital adequacy of our lenders. And a substantial amount of that capital needs to be held in a third party collateral account as a AAA letter of credit for our benefit to effectively assure their performance under their obligations to us for sharing of risk.

Our underwriting standards are dramatically different. They do rely heavily on value. But maybe even more importantly, they rely upon debt service coverage of actual collections and expenses today. In other words, the actual income that's enjoyed today by the property, net of expenses, as opposed to permitting our delegated lenders to go out and look at what they think might happen a year or two from now and basing a mortgage amount on that projection.

I think that's been quite successful. It takes a lot of the subjectivity—not all of it—I agree with Peter, there's still a lot of art left in underwriting a multifamily loan, but it takes a fair amount of the subjectivity out of the underwriting process.

Third, the fee structure—and I think HUD properly pointed out that the fee structure that coinsurance had incented production and didn't really incent ongoing viability or quality processing and quality loan performance. Our fee structure is much more skewed toward the back end. In fact, early on in the program, our delegated underwriting program, in most instances is a break-even or money-losing proposition, but it's an annuity for the lenders. It's a profit-making program if they have good loan performance over time.

Administration and monitoring is something we've talked about and just cannot go unmentioned again. It is absolute folly for any secondary lender or secondary source of credit to permit a concentration of risk in a portfolio to the degree that HUD-FHA's concentration of risk existed for much of the 1980's and still exists to a substantial degree. That resulted from the way the program was initially introduced and operated—precommitment reviews that lagged for months and sometimes years, allowing one or two lenders to get out in front of everybody else in both programs and do huge volumes while everybody else was going through an interminable application approval process.

In addition, Fannie Mae looks carefully at each loan for a period of time after the leader is approved. We look at extensive packages of underwriting material on an ongoing basis, and we have the ability—and this is a key piece of the monitoring process—to levy penalties against lenders who do not perform well. The penalties stop short of putting lenders out of business. FHA faced several situations in the mid-1980's and the late 1980's where they had the choice between administering penalties that would effectively put a lender out of business—and therefore bring them down and force a major Government loss—or permitting the lender to continue in the business with the hope that they will stay viable from additional fees earned but with the risk of additional problem loans.

There are a series of intermediate penalties that we have available to us, and we use them with some frequency. They have been extremely effective as measured in terms of improving lender performance, as well as in terms of mitigating our risk. When we find a lender that violates our guidelines. We penalize them with a higher degree of risk-sharing which mitigates our risk and gets their attention very quickly.

Last—and this is an area that I'm not sure the Government can be as effective as private industry, is the notion of a franchise system. We hope to create value in the license itself which exceeds the value of the deal that they are doing today. Life companies have done this for years with their correspondent lenders without any risk-sharing. The correspondent values the franchise they have with the life company so much that they look very carefully before they sell the life company a loan that they have any questions about. That's without any risk-sharing.

Now you add an element of risk-sharing with the franchise value, you really get a primary lender's attention. They don't want to do anything to Fannie Mae, in this instance, that would jeopardize their license.

Unfortunately, many Government programs tend to be entitlement programs—in other words, if you cross or jump over the program requirements hurdle, and just clear it, you're in. The Government sets up minimum standards and anybody that meets the minimum standards can become a participant. I think in a delegated system that approach may not work as well as a program where the people who jump over the hurdle the highest get in and where participation is limited in numbers so that they very much value their ability to participate.

Senator **Mack**. I raised the question a little bit earlier about risk. Again, I assume somewhere along in this process as it was developed that the theory was if the coinsurance lender had a sufficient amount of risk that there clearly would be the incentive to underwrite good loans. And one of the statements that seem to be accepted as truth around here is that, as the program evolved, that the coinsuring lender had no risk.

Now I've heard that that's really not the case, that the lender did in fact have risks, but then I guess the bottom line was that if the coinsuring lender had no capital there really was no risk. Is that a fair conclusion to draw?

Mr. **DelliBovi**. Exactly. The risk is not significant if the party at risk doesn't have any capital to lose. They're really not at risk.

Senator **Mack**. Go ahead. You wanted to make a response?

Ms. **Beasley**. You say if the party had no capital, in all cases the party had at least a million-five before they could start playing. $500,000 of that could be in the form of a letter of credit. But in many cases they had built up capital as companies.

Larry Dale talks about the value of the franchise, the value of the license. We're working with Larry's program and find it excellent and we value that license dearly.

I think if you look at the chart over there [Chart A, p. 660.] in May of last year coinsurance became an unworkable program for all the lenders involved in it. It became nonproductive for a lot of reasons. Then in January it was cut off.

Look what's happened there with the default in loans. Suddenly the license had no value.

Senator **Mack**. I'm not sure I followed that.

Senator **Graham**. It sounds as if the license had no value because essentially the value was eaten up by the people who had the license.

Ms. **Beasley**. No. What happened is you had a lot of lenders who had some loans that they were carrying and their income stream was cut off. Now I would really like to know if those numbers for defaulted loans include all of the loans that were turned back to Ginnie Mae because the lender went under for lack of capital because in many cases loans turned over to Ginnie Mae include a lot of healthy loans, good loans, loans that were underwritten well, but they were in the hands of a lender that just couldn't survive anymore. I don't know whether those default numbers are only bad loans or a combination of bad loans and good loans in the hands of lenders that went under because of lack of capital.

Senator **Graham**. Mr. Monroe.

Mr. **Monroe**. Basically, those are loans that are going bad because when they were originated they were bad loans. As I said, programwide, we are now at a 20 percent default rate in terms of all our loans and what Larry Dale mentioned before was very interesting.

While the coinsuring lender initially had to put up $1,500,000 in "sound capital resources", on the margin they only had to add capital equal to a third of 1 percent as they went forward. Therefore, there was a tremendous incentive to have that kind of concentration and as that occurred it doesn't take a rocket scientist to understand that if there's a 20-percent default rate in the program and there's only one-third of 1 percent of incremental capital going in there to protect against that, that something has got to crash.

What we're really looking at, as I think I said before, this is the result of these huge incentives to overmortgage without any check on the part of the Government, without any ability to go back and say, well, that mortgage is too high.

Senator **Mack**. There are just a couple of things that keep flowing. One is that the idea has been circulated that the coinsurance lender had no risk because FHA insured the mortgage or the securities I guess.

Is that a true statement? Somewhere along the line this theory had been developed that there is a difference in my mind between a program set up to impose a degree of risk on the lender and one that, while it said that, didn't really in fact impose it because of the overlay of the FHA insurance.

Mr. **Monroe**. As Professor Edelstein said, there have to be concepts of risk-based capital. What was happening was the risks were just enormous and nobody even realized how high the risks were because nobody realized how great the overmortgaging would be that would take place. Yet the level of capital that the coinsurers were required to keep was very small and they were able to upstream their upfront profits, just throw them right out of the company and leave this pittance of capital within their companies. It may not have been a small amount of capital in an absolute sense. A million and a half is a lot of money. But when you see these portfolios being as large as $2.3 billion and so little capital, there was no relationship between the amount of risk that these folks had and the amount of capital that they kept within their companies. Again, that's not true for all coinsurers, but it was generally programmatically true. There are some definite exceptions.

Ms. **Beasley**. Senator, if I could clarify that, the coinsurers bear the risk of the first 5 percent of the loan balance and then 15 percent of any other losses on that loan with HUD picking up the other 85 percent of losses after you take the first 5 percent. So we have a 20-percent exposure on all loans at all times whether or not Ginnie Mae mortgage-backed securities are used or HUD insurance is in place.

I would agree with Mr. Monroe that the industry in general was undercapitalized and because of that concern a number of us, through the Mortgage Bankers Association, went to HUD, sat down with HUD, and tried to have them improve their capital requirements.

We suggested that they use the same requirements that Fannie Mae uses under its program because that's a very viable, workable program and had hoped that HUD would adopt those capital requirements. I think that it would have been the answer.

However, what happened in our discussions with HUD is that they came back with a requirement that basically tripled the requirement for the lenders and were so high it would have been impossible for us to obtain those kinds of fees from the borrowers in order to set aside the capital that HUD would request.

So at that point we told HUD that that didn't work and shortly thereafter the program was terminated.

Mr. **DelliBovi**. Senator, it's important to point out that when we look at the 5 percent and the 15 percent and all these numbers that are thrown around, the Colonial House project, in which we were at risk for $47 million, we were able to sell it for $8 million. That is a valid example of the kind of overmortgaging that was going on. They could have been at risk for 50 percent and they still would have made money on that deal because they walked away with $47 million and all we could get was $8 million.

I think Mr. Craren from Price Waterhouse can shed some light on this entire area because he did extensive studies for us on this aspect of the problem.

Senator **Graham**. Could you hold just a minute, Professor Edelstein, because you raised Colonial House, which is another project that came up in one of our previous hearings and I've been curious about one aspect of that project, which was that at the regional level there had been a recommendation against mortgaging at the level that was finally granted and then there was apparently some opinion by counsel at the central office that there was almost a legal obligation to underwrite at the level which had been recommended by the coinsurer.

Is that an accurate sequence of events and, if so, what was the legal imperative that was cited as the reason why HUD was mandated to provide a mortgage at the level that the regional office thought was excessive?

Mr. **Monroe**. First of all, you're correct. One of the great frustrations of this program for our field staff and others was as follows: That once the coinsuring lender had made a commitment to insure a loan, HUD did not have the right to go in and reverse that commitment unless they could show either fraud or misrepresentation, which is very, very difficult to prove.

So in many circumstances, even after I got involved in the program, we would see a mortgage going down and our field office would tell us that it's 25 percent overmortgaged and there wasn't anything we could do. That's a very, very frustrating position to put anybody who is in the Federal Government in. I think that's basically what happened in the case of Colonial House. It really couldn't be stopped. In retrospect, the numbers were so wrong that maybe grounds could have been easily found for stopping the deal.

What we've had to do, Senator, we have suspended 7 and put on probation 6 coinsurers, totaling 13 out of the 39 coinsurers. All we could do was after the deal happened, then we could go in and either suspend them or put them on probation. When we put them on probation it gave us back the right to review the loans going forward.

But when you see a $50 or $60 million transaction occur and you can't do anything about it and you know it's wrong, that's just not the way to run a Government and I know you feel that way.

Senator GRAHAM. But the chains were self-imposed. It was in the initial development of the program that you so restricted yourself that you ended up in this position.

Mr. MONROE. Right. But that was the delegation of underwriting and people relied on those numbers and the whole process took place.

Senator GRAHAM. Delegation is a concept that infers the ability to withdraw if you find that your agent is not performing in an appropriate manner. Apparently, your delegation was of a more permanent and irreversible character.

Mr. MONROE. I believe I referred to it as the abdicated underwriting system.

Mr. HIPPS. Senator, if I might, because I think that's an important point, particularly with respect to Colonial House, the reason, as I understand it, that HUD took the position it could do nothing to stop Colonial House really had nothing to do with the underwriting. It had to do with the fact that the Department had delegated its legal authority to commit the Government and that that commitment had been made by the coinsurer. As I recall, it was a matter of the regulations and the way they were written, but I think it's important to understand that there was nothing to prevent the Department, which was well aware of the circumstances surrounding Colonial, from having taken immediate action to deal with what they perceived at the time was underwriting irresponsibility and that it was a number of years before any effort was made to deal with that particular lender.

Senator GRAHAM. Professor Edelstein.

Professor EDELSTEIN. There are a couple comments that I think need to be tied together. One comment which has been repeated and I think is correct, underwriting for multifamily is clearly more difficult than single family.

And value analysis is really looking at cash flow. Those are not separable. Sometimes it appears to be, but they are not.

Basically, the value of the property is the capitalized value of the income that's expected.

Now obviously, trying to project incomes forward is difficult and if you're talking about predicting what happens to markets around the property—and that's what you're really doing—that is tricky. That doesn't mean it can't be done without abdication.

It also suggests that probably HUD can never do it as well as someone who's in the marketplace. This suggests to me that coinsurance is precisely the way to go because then you get a double check. HUD can do as well as it can, and you get someone who's in the marketplace who as a coinsurance lender has risk, and then he's also going to do the best job he can and you won't get the cat and mouse game, which I've seen developers and people play with cap rates and projected cash flows. But if they have something at risk, if they play the game, they end up being the mouse and not the cat.

THOMAS CRAREN, PARTNER, PRICE WATERHOUSE, WASHINGTON, DC

Mr. CRAREN. Could I make a comment about risk?

Senator GRAHAM. Mr. Craren, I know you've just completed a major study for the Department on this program. What I'd like to do is to use your comments as a bridge between points two and three. We've been talking about some of the design and conceptual problems. Question three is essentially the same question: What are some of the implementation problems? Since you've been looking at both design and implementation, could you give us a bridge between those two and then we will open it up for questions or comments on implementation.

I understand, Mr. DelliBovi, that you are going to have to leave at noon, is that correct?

Mr. DELLIBOVI. Just about that time, yes.

Senator GRAHAM. So what I'm going to do is try to accelerate question three responses somewhat so that we can spend some time on question four while Mr. DelliBovi is here and then go back and pick up any further comments on three and four.

Mr. DELLIBOVI. I appreciate that, Senator.

Mr. CRAREN. I have just a couple of comments. First, it's been brought up that the coinsurers are responsible for about 20 percent of the risk, and the good ones that have good portfolios are. They pay 20 percent of a claim.

But our study focused on systemwide risk-sharing. On a systemwide basis, that risk-sharing did not work. For the good people, yes, they took their 20-percent risk, those people who had small default rates. But the preponderance of the coinsurers had substantial default rates and the appearance based their low recovery rates that they were overmortgaged.

The result was it was flawed systemwide. That was our conclusion. We tend to view it myopically as individual companies, but it isn't. We are talking about a systemwide process.

Now with respect to risk, we've been talking about Ginnie Mae and FHA and the professor I think raises a valid point. We think there was nothing really at risk. I think the way you can understand it is to say, look, absent the Ginnie Mae full faith and guarantee, would that investor have invested in that mortgage even with 80 percent FHA insurance. And I think the answer is he wouldn't. The investor was providing capital for that mortgage because the Ginnie Mae security is highly rated. It's a Government-backed security. And it's somewhat analogous to deposit insurance. You have access to money that's guaranteed, but how you lend that money, the riskiness of how you lend it, isn't dependent on how you raise the money to begin with.

So, while the concept may be valid, that if you have true risk the players will tend to act properly—I think that's been proven—in this case the low level of capital-at-risk created incentives to abuse the program. That was the key point we were making.

Senator **Mack**. Let me raise this question, though. There are two different aspects I think that you mentioned. One is from the standpoint of the lender, you're saying that there was risk from an individual perspective. Systemwide, it didn't work. Then you made the comment that from the standpoint of being able to sell that loan the only reason it was sold was because of the 100 percent guarantee.

The question I would raise at this point, based on what you said earlier, without that guarantee, you couldn't sell that loan anyway, regardless of how well capitalized the lender may have been. Is that a fair statement?

Professor **Edelstein**. Not exactly I think. There are mortgage packages that are sold that are not Government-guaranteed. For this to happen, there has to be third party investors, willing to buy the "paper," and they are not going to underwrite and analyze the underlying mortgages. If they have faith that payments will occur, that the quality of the mortgages is good, and that someone stands behind the mortgage payments, they will buy the paper. If for example you get an S&P rating on a CMO, which may have Ginnie Mae mortgage or have private sector mortgages, conventional mortgages—they typically have private mortgage insurance for the CMO issue.

The invertures in the paper, the [MO's in our example] have to feel that there's some way that timely payment will be made. Otherwise, the outside inventor market won't buy it. And there are a lot of ways of accomplying these assurances for the investors.

Mr. **Craren**. It is important to distinguish between Fannie Mae and HUD. Fannie Mae is buying the mortgages, Larry, for your own portfolio, so you're making some judgment about that loan itself and whether it presents a risk you would like to take. The point we're making here is that HUD had to accept the risk automatically, because of the way this program was designed. The capital was going to flow, no matter how good or how bad that loan was. There was no decision on the part of the security-holder who was providing the capital for that mortgage, of how good or bad the loan was, and whether capital to fund the loan should be provided.

Mr. **Dale**. Your point is well taken. Fannie Mae is buying most of these loans for portfolio. However, I would make the point a little differently. Unfortunately risk-sharing on the loan between FHA and the coinsuring lender is analogous to the savings and loan problem. If you ask Jim Montgomery at Great Western if he takes the recourse he gives us seriously, he is going to say, yes. He is bearing the risk because he's got a lot of capital, Great Western is a well capitalized thrift and it has a lot to lose before Fannie Mae is ever going to lose a nickel. On the other hand, if you apply this to some of the failed savings and loans, they obviously had no risk. Their only motivation was to make the next fee and stay alive for another month. Further, they were playing with the Government taking the risk. That is the analogy you're seeing in coinsurance on the credit side of each individual loan.

Senator **Mack**. What you're saying is the incentive was there to make any loan. Once you made that commitment you were guaranteed a source of placing it because of the insurance.

Mr. **Dale**. Indeed, it was almost perverse, because at some point when a coinsuring lender knew they were under water they had to originate the next deal to make the payroll next month. It almost worked in a perverse manner.

On the secondary market side, there is a separate issue. I agree, Tom, we are buying DUS loans for portfolio, but quite frankly we are also guaranteeing them with securities and it doesn't matter to us whether we buy a loan for portfolio or whether we guarantee it using a security. We would use the same set of glasses in looking at the loan and making the credit decision. The only difference between the two is the interest rate mismatch, which obviously we have to allow for and fund against if we are buying a loan in portfolio. That is, we must make sure that the cost of capital is reflected in the price paid for of the loan. In a security, the finding uncertainty is left as a risk for the investor.

From the underwriting and credit risk perspective, we use the same set of glasses and we evaluate the loan in the same way.

Mr. **Craren**. But my point is, that at least you evaluate it.

Mr. **Dale**. Yes.

Mr. **Craren**. You evaluate the credit and I think the investor in a Ginnie Mae is buying it because he knows it is a full faith and credit security.

Mr. **Dale**. That's true, but it seems to me that's the function of the secondary market. It does not matter whether it's Freddie Mac, Fannie Mae, Ginnie Mae or, to some degree, an S&P or Moody's rated structured AA security. The purpose of the secondary market entities—and the reason they earn a fee—is to take a marginal sliver of the risk so that the investors have a no-brainer credit decision. The investors are buying agency backed paper. They are buying the timely payment of principal and interest in accord with the schedule that they received. That's the whole point of the secondary market; to make the real estate risks invisible to that secondary market investor who may be in Japan or Germany or in some pension fund that wouldn't know an apartment building if it ran into it.

Professor **Edelstein**. Let me suggest that the good guys versus the bad guys, which is the notion that we have different types of lenders here, is true. But the system was designed to enhance incentives of bad guys and I don't like to make like white hats and black hats, but I think that's appropriate.

If we take that example we talked about, a $2.3 billion portfolio, and if you say that the lender could basically get 2 percent fees out of that probably total, he would walk away with about $45 million right there at the loan originations. He puts up $1.5 million and then adds marginally about $8 million. So he gets $45 million and he has $9.5 million if he puts it into the pot timely.

Most people would put $9.5 million in order to get $45 million if they could exit out of the operation. So there's a real but perverse incentive under the way the coinsurance was structured to cheat, to say, hey, I've made it up front. If the market turns around—it's a bad loan and we know that, but if the market turns around and it becomes good, I'll make some servicing fees on top of that or something like that, great.

But you can see that these numbers just don't pencil out. If you keep the $45 million in there, obviously you have something at risk. If you're more scrupulous and honest, you probably would. But you can see that at the margin the incentives are all wrong. That's a design fault, not a concept fault.

Senator MACK. Were these kind of comments raised at the time the program was put into effect?

Mr. HIPPS. I'm really not sure I can answer that for you, Senator, except to say that to the best of my memory, the only thing that went on inside HUD at the time the program was initiated was an analysis performed by Housing's Office of Policy which was aimed at determining what an appropriate fee splitting or mortgage insurance premium splitting arrangement would take place between the coinsurer and HUD given the respective risks that the two had.

Beyond that, I have really no memory that would shed any light on that.

Mr. DELLIBOVI. Senator, again, I can only talk about what's happening now, but I can't miss this opportunity to point out that one of the administrative steps Secretary Kemp has taken is to initiate something we call frontend risk assessment under which when a new program comes along or new thought we send it over to the IG's office, among others, and let them look at it and try and figure out how someone would game us if we did it. We have done this with most of the new proposals and we're doing that now routinely to do this frontend risk analysis, so we can be sure that we know what might happen.

Senator GRAHAM. Mr. Greer and Mr. Craren, I would be interested in your assessment of how the Department is currently functioning. Mr. Craren, you made a number of specific suggestions as to what needed to be done in order to avoid a repetition of this. What's your report card as to how well those recommendations have been put into effect?

Mr. CRAREN. I think the Department is doing well, given the magnitude and number of problems they have to deal with, which are many, as I'm sure the Under Secretary would tell you.

They have so many problems to solve—and many people want them solved next week or next month, but a number of the problems aren't solvable in that sort of a timeframe. I think the Department has put a structure in place, and I'm speaking of the chief financial officer, installing accountability and upgrading systems, that will ultimately solve them. But I cannot assure you that there might not be something else that could happen in a couple of months, maybe another big lender goes under? I don't know, because the problems are deeper than that and the fixes will take longer.

But I think HUD has put the structure in place that will lead to, with continued diligence, successfully addressing the problems and the issues we raised, both in our FHA audit and in this study.

Senator GRAHAM. Mr. Hipps, in your statement on page 12, you make the statement that, "no matter what delivery system HUD uses, aberrations and abuses will be more likely to occur if the current lack of monitoring and oversight by HUD continues. I do not currently see any commitment to proper oversight."

Is that a statement that is effective as of March 27, 1990?

Mr. HIPPS. That's a statement that is an expression of my opinion as of March 27, 1990, Senator. I've said this before in other forums and I believe I'm correct in saying that Mr. Craren's study also addresses this issue, that without proper monitoring and oversight it makes no difference what system you have, there will be abuses; and I would contend that a major part of the problem that we are discussing here today could have been avoided with proper management and oversight. That certainly is not the responsibility of the gentlemen at the other end of this table from HUD today because it all occurred prior to their watch, but nevertheless, during the developmental process of coinsurance the inspector general's office of HUD certainly raised the question of concern over monitoring and there certainly were rhetorical commitments made to that monitoring which, in my opinion, were never carried out.

I do not believe—and the reason for my statement is current—is that HUD has not been given nor currently has the manpower or the money dedicated to monitoring this program or any other program like it. My personal view is, without the manpower and without the dollars to support that manpower, the monitoring will not take place.

All of the remote monitoring in the world, with data processing systems, will not be totally effective. You have to have people to look at the underwriting process. You have to have people to review the appraisals in the field to spot check them, to spot check the architectural work, and without that, you ultimately have problems.

Senator GRAHAM. Mr. Greer, what's your assessment of the current implementation within the Department of its managerial responsibilities?

CHRIS GREER, ASSISTANT INSPECTOR GENERAL FOR AUDIT, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, WASHINGTON, DC

Mr. GREER. I guess in a nutshell I would have to totally agree with George Hipps that in the past we did point out the monitoring problems. We believe there is an opportunity within the Department to correct many of the past problems. However, in addressing those problems, we also have to deal with the new things that are going on at HUD and one of my expressions recently was, to get from here to there requires a staffing bubble and we need to address the monitoring problem as we try to work through that.

I think maybe in 2 years, after the problems have been dealt with, then perhaps we can get back to a staffing level that might be appropriate. But we have to deal with the current problems and design new programs and get on with the business that HUD is designed to do. Monitoring and financial management systems to carry out that monitoring are the cornerstone of any good management system and that's what was lacking in the implementation of the coinsurance program in our view.

Senator GRAHAM. Mr. DelliBovi, what have you requested in your current budget submission to Congress relative to management and oversight functions and what's your assessment, if Congress provides those resources, of your ability to accomplish an acceptable level of oversight?

Mr. DELLIBOVI. Mr. Chairman, before I get to the specific number, let me say that shortly after the Secretary's decision I personally visited the coinsurance section of HUD, met with the staff involved in trying to cope with this workload, and have an ongoing relationship between my office and those people in housing who are dealing with this problem.

Happily, we don't have to just look at the current budget submission because the Congress was gracious enough to give us an increase in staffing in the budget that we are now enacting. Just last Friday, I signed off on additional staffing for the multifamily area that will be dealing with this with additional people.

The problem though, Senator, and I must tell you very quickly—you were a Governor. I know you have been an executive. Senator Mack has been in the business world. It's one thing to hire people. It's another to train them and get them up and running and that is a slower process. We have today the resources that we need. We are requesting additional resources in our current budget submission on an additional 500 people in housing. We have initiated another one of the Kemps' reforms, which is workload indicators. I only got around to approving the staff increase last Friday because it took housing that long to show me, give me the workload indicators and what outputs we could expect.

One of the problems with HUD in the 1980's I believe is that there was a focus too much, too often on inputs—how many dollars they got and how many staff years—and too little on outputs. We are trying to tie the two together.

If we are going to ask for more staff, I want to be able to tell you what additional product you will get.

Let me wind up by pointing out that there is a distinction that needs to be made between monitoring and enforcement. We have not significantly increased our monitoring, but we have done a very vigorous job in enforcement—so vigorous that we've closed down the program. Previously, enforcement was nonexistent at HUD. At the same time, we are monitoring. The precommitment review process that we've put in place is certainly a monitoring exercise.

One of the side products of reform at HUD overall is that we are not just monitoring. We are also enforcing. And I know in a program that many people view as an entitlement—certainly HUD has many entitlement programs—there is often a hesitancy to enforce, but we have to enforce the programs to see that they are run right. That doesn't mean taking benefits away from people who are intended to get the benefits, but it certainly does mean taking tough steps with people who would siphon off those benefits.

Senator MACK. Let me raise a question with the basic point that was raised in the beginning of this as to why HUD went into the coinsurance program and the monitoring question that you raised or the IG raised at the time.

What we've heard is that HUD didn't have sufficient staff. There was great backlog of applications and one of the ways of dealing with this was to shift from HUD to the coinsuring lenders the responsibility of underwriting and servicing, therefore freeing or lessening the demand on HUD.

Was it the IG's opinion that even with that reduced workload that there was sufficient or insufficient staff to take on the responsibilities of monitoring?

Mr. GREER. Senator, we didn't do an in-depth analysis like has been done recently on the numbers, but when we went from an underwriter, which HUD was at the time, to a monitor, that function is totally different. You need different people with different skills and I don't think the Department ever thought about it or prepared themselves to take on that different function. They simply got the program into the industry without thinking about the skills needed to monitor, No. 1; and No. 2, the financial systems or the wherewithal to detect the problems on a timely basis.

Senator MACK. In the analysis that was done at the time when you came up with the questions with respect to monitoring, were there other areas of concern that you raised at that time as well?

Mr. GREER. About the structural design flaws that have surfaced since that time, I don't think we in our office were sophisticated enough to do the types of analyses that have been done since then about capital requirements and so forth.

Senator MACK. In retrospect, do you think those are areas that you should?

Mr. GREER. Yes, sir; and I think Mr. DelliBovi pointed out that he and his staff are working closely with our people and this front-end risk assessment will be done in the future.

Senator MACK. Have there been in the past questions raised within HUD that said that the scope of the IG is not broad enough, that they ought to have more resources, that they ought to have more capabilities?

Mr. GREER. We have often questioned whether we have enough resources. Recently, we, too, have enjoyed increases in our budget. The technical qualifications of our staff to do actuarial studies as Tom Craren and Price Waterhouse have done, we would need to go out and hire those same types of individuals and firms because we simply don't have that capability on staff.

That's probably something we should look at and see if we need to develop that capability.

Senator MACK. Just out of curiosity, what is the size of your organization?

Mr. GREER. About 480 individuals today onboard. Our 1991 budget is for 550, somewhere in that neighborhood.

Senator MACK. Compared to, say, 1985?

Mr. GREER. It's about the same. Our staff has stayed fairly constant through the 1980's.

Senator MACK. So 1981 to 1990 would be——

Mr. GREER. Maybe 10 to 12, in that neighborhood.

Senator **Graham**. I'd like to follow up on that line of questioning. If the reason we went into coinsurance was to overcome the constipation of the system as it was operating before 1983 and, if, as Professor Edelstein has stated and also Mr. Hipps and others in their prepared statements, a functioning program of insurance or coinsurance is a necessary part of the Nation's ability to meet its affordable housing goals, what steps has the Department taken to see that it has the capacity to respond in this post-coinsurance era?

Mr. **DelliBovi**. Let me begin, Mr. Chairman, by saying that if the reason was because there wasn't enough staff, it was the wrong reason. That certainly is not the reason that we promote privatization.

Senator **Graham**. We spent 30 minutes this morning asking what was it prior to 1983 that led to the creation of coinsurance and my notes indicate that that was the consistent theme.

Mr. **DelliBovi**. Certainly the folks that made those observations worked at HUD at the time. Whether they were the ones making that decision, I don't know. But my point is, if that was the reason, I would say it's the wrong reason.

Senator **Graham**. What do you think was the reason prior to May 1983 that led to the establishment of coinsurance?

Mr. **DelliBovi**. I cannot speculate on that, Senator, because I wasn't there. I would have hoped that if they promoted privatization it was because they thought it provided better product for the Government and not to cover up some staffing omission. But that is the wrong reason to promote privatization.

I also pointed out it wasn't privatization. But they didn't focus on the problem. We are attempting, as we look at the need, to provide insurance for multifamily projects. It's important to keep that in mind. Coinsurance is a delivery mechanism. It's one way to get to the buildings what they need in order to be marketable. What they need is insurance so that the funds will be provided either in the securities market or by lenders. We believe that full insurance, operated under a delegated processing system, can be the answer. It's an answer that will enable us to leverage the abilities of people outside the Government who can do some of the processing work that is labor intensive and field intensive but still provide us with the ultimate decision-making process. That is the type of program that we are in the midst of developing as a replacement for the coinsurance delivery mechanism which, by the way, only delivered about 5 percent of the multifamily housing structured during the period of its existence. It wasn't providing the lion's share of the market by any means. Peter, you might want to comment.

Mr. **Monroe**. According to our Office of Policy Development and Research, the number was between 3 and 4 percent of all newly constructed rental units was being provided by the 221(d)4 program. Those are our numbers.

Senator **Graham**. Well, I would be interested in the comments of others as to whether you believe that the system that the Department is now committed to, a 100 percent insurance system, with some delegation of specific functions, will achieve the objective of providing financing for affordable housing and multifamily facilities.

Mr. Hipps, you raised some questions as to whether you thought that was feasible.

Mr. HIPPS. No, Senator, I don't have any doubt that a delegated processing system or a well-staffed internal HUD operation that can respond to its clients in a timely manner, either system, would provide a delivery vehicle, which is what I think we all feel is necessary.

My comments were strictly aimed at the fact that no matter what the system is, if you don't have the commitment to monitor it and manage it, and as the Under Secretary referred to, enforce the rules of the game, that you're going to have problems with it. And that would include an in-house system with HUD staff.

But certainly there's no reason why a delegated processing system with full insurance cannot work as a delivery system.

Senator MACK. Can I raise what maybe where the conflict really lies, and that's under a system in which the decision to lend or not to lend in essence is made at HUD, it is going to be made by a system that many say would discourage people from making the decision to lend to what might be marginally risk, and therefore the processing is designed in such a way that no matter how many people you have—the system is one that is going to be slow in its processing, which is not really people-driven. It's really driven by the concern about—I have to make a decision here that not only my immediate boss is looking over my shoulder, but there are all those guys down there at Capital Hill and all the others who will be asking those kinds of questions. So that's one side of it.

The other side and I assume probably one of the theories behind delegating the underwriting was the incentive in the coinsurance lender was to make a decision, to get this process going, to make the money available. And there lies the difficulty. How much of those two points of view are you going to take into consideration in making the decision about the design of a new program?

Is that a fair analysis of the problem?

Mr. DELLIBOVI. Certainly to perform the kind of almost due diligence that's necessary to evaluate an investment takes a bit of time. I think it's worthwhile from the Government's point of view. I think the Government's money is just as green as anybody else's money and it ought to be carefully invested. I believe we can develop a system that will be responsive to the needs of the marketplace. We're talking about major construction projects which in most instances the pipeline and the development processing is very long. But the alternative is to keep running up dollar losses like we have on that chart and it seems to me in this environment—I don't know what Government environment we were ever in that we could afford those kinds of losses, but we certainly can't afford them in this one. That is a big chunk of money there, $1.6 billion, and still growing.

Ms. BEASLEY. Senator, the Mortgage Bankers Association has proposed a delegated processing program to HUD and we are not here today to argue whether or not coinsurance should have been maintained. When this administration started monitoring, we in fact welcomed it. We were pleased to see that they were monitoring it. We would have preferred that the program be repaired rather than terminated, but delegated processing, if it were implemented quickly and if it were staffed properly, could be the answer.

Our concern right now is that there is a crisis in availability of capital for older apartment projects and for new construction, particularly for low- and moderate-income individuals. The thrifts are out of the business. Life companies want only top quality, expensive product. As you look around you will see that the banks now are starting to pull back a little bit. There is not very much capital available to preserve and to renovate apartments.

So we think it is essential that HUD get delegated processing off and rolling very quickly and the proposal that we have put forth has private industry doing all of the due diligence work, commissioning the appraisal, commissioning the architect to go out, commissioning the engineer to go out and assess the cost. All of the work that is so time consuming and was so time consuming under full insurance, which by the way took about 10 or 12 professionals in every field office to do, we have suggested that private industry could do a lot of that and then go to HUD and use HUD like our loan committee.

HUD would have the final determination of mortgage amount and the final determination of rents and expenses. That would minimize the amount of staff needed to make the program work and it would get this country back where it ought to be with Federal leadership for housing preservation and production and could do it very quickly.

Senator GRAHAM. How closely does that description come to what you are intending to put into effect?

Mr. DELLIBOVI. Well, Mr. Chairman, I'd like to ask you to take the Mortgage Bankers Association's news release describing the program and put it in the record. The headline says, "New delegated processing insurance program" and then on the last line of the second page down at the bottom it says, "MBA has developed recommendations for a full insurance delegated underwriting program." Exactly the kind of program we had to get rid of.

MBA News Release

FOR IMMEDIATE RELEASE **Tuesday, March 27, 1990**

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NEW DELEGATED PROCESSING INSURANCE PROGRAM WOULD HELP SAVE LOW-INCOME RENTAL HOUSING

WASHINGTON, D.C. -- The Department of Housing and Urban Development's (HUD) abrupt recent shut down of its coinsurance program for multifamily properties makes the need for a substitute mortgage program urgent, a leading housing spokesman told a Senate Committee today.

Gaye G. Beasley, Chairman of the Mortgage Bankers Association of America (MBA)'s Affordable Housing Task Force, said "There is a clear need for a constant and reliable source of long-term, fixed-rate financing in the private sector for low- and moderate-income multifamily housing. The current HUD programs do not meet that need." Beasley added, "The unmet market need, which drove the initial creation of the HUD multifamily coinsurance programs, still exists today."

Beasley's remarks were made during a special roundtable hearing on an historical examination of what went wrong with HUD's multifamily co-insurance program held by the Senate Banking Subcommittee on HUD/Mod Rehab Investigation.

Beasley, who is also President of the Patrician Mortgage Company, of Washington, D.C. and Jacksonville, Florida, emphasized that "The coinsurance program has experienced problems due to the design of the claims procedures for the program, an inability to prevent some lenders from continued participation in the program, and an acute lack of experienced HUD staff to perform oversight and monitoring functions. Despite these problems, the program did help finance over $10 billion of affordable multifamily rental housing units," she said.

"Since 1937, when the FHA multifamily insurance programs were first implemented, over 3.8 million units of multifamily housing, including 313,000 coinsured units, have been produced, and over $75 billion of mortgages, including approximately $10 billion in coinsured loans, have been insured by FHA," said Beasley.

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"We believe that attention must be paid to working out the phaseout of coinsurance and the implementation of a replacement program or HUD's losses will increase," said Beasley.

Beasley said, "Careful monitoring combined with a reasonable increase in lenders' capital requirements, would have minimized the losses to the Government National Mortgage Association (GNMA), the General Insurance Fund, or the U.S. Treasury from co-insured loan or co-insured lender defaults and have made the program viable."

"In an effort to further minimize losses, MBA suggests that efforts be undertaken to establish a reasonable program for conversion of coinsurance portfolios to full insurance. One such proposal includes providing HUD with additional loan loss reserves and the entire Mortgage Insurance Premium (MIP)," said Beasley.

According to Beasley, MBA has developed recommendations for a full insurance, delegated processing program. For such a program to be successful, it will be necessary to have:

- Increased monitoring and more rigorous enforcement of oversight.
- Increased funding for travel, training and staffing of HUD headquarters and field offices, since HUD will be responsible for functions previously delegated to coinsurers.

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MBA, headquartered in Washington, D.C., is a national real estate finance trade association representing 2,600 member mortgage companies, savings and loan associations, savings banks, commercial banks, life insurance companies, and others in the mortgage lending field.

Mr. DELLIBOVI. So we certainly will look at their recommendations and a number of recommendations. Our process is going to go through a rule-making procedure and people will have an opportunity to comment.

Delegated processing we like. Delegated underwriting got us where we are on chart A. This news release starts out talking about delegated processing but winds up talking about delegated underwriting. And I will tell you in the strongest possible terms, we are not going to make the same mistake twice.

Mr. LASKO. Let me address that if I could.

Senator GRAHAM. First, I recognized Professor Edelstein and then Mr. Lasko.

Professor EDELSTEIN. I think their use of the parlance here is leading to some confusion. Whether HUD bears the risks as ultimate guarantor or not, I think there are intermediate stages which I will call coinsurance—and perhaps that's the way it needs to be worked—where if you have someone doing something for HUD and he's not doing it as a fee structure so he gets his money and walks away, some appraisal, some processing, you won't get the same quality as if he had something at risk that relates to his performance of the service. That's just common sense. I think that the notion of having coinsurance where the person that is issuing the loan has something to lose over the long haul is very important. That doesn't permit abdication of underwriting by HUD. HUD still has to underwrite because they are on the line, even if they could lose 80 percent of the value—they're still on the line for the lion's share and they have to do their job.

But what it will permit is expeditious servicing, and expeditious processing. We haven't talked about the operational side of permitting workouts and foreclosures before they become foreclosures to save money. I'll leave that as something that's obviously important and you have to have incentives of the person who makes the loan to do that. Otherwise, you get the Government in at the foreclosure stages and they are not going to perform well at that stage.

I think there are advantages to coinsurance that we haven't mentioned, and they relate to what I call moral hazard and adverse selection, which are standard words in the insurance trade. If you have someone not at risk, then there is at the margin some incentive to behave in a way differently than if you are at risk. It makes sense. If I have no deductible, I just report all incidents to the insurance company. If I have deductible, I start worrying about that and I behave differently.

Also, there's adverse selection. If I'm a lender say in Dallas in the field, I should know much more about my marketplace than someone working in Washington, which means I can tell projects that may look the same in terms of numbers and appraisals. I will hold better projects for my own portfolio, and I'm going to pass on to the Government the lowest quality projects that meet the minimum standard set. That's adverse selection.

So there is good reason to have people at risk in coinsurance for moral hazard reasons and adverse selection reasons irrespective of the notion that you can't abdicate underwriting. Obviously, you can't abdicate underwriting. If you do that, there's no program that will work. There's always a way to beat it. So I would argue that if we're going to be more careful in the future and run loan insurance programs right, they should be coinsurance programs. They should have quality underwriting. They should have monitoring because there are going to be economies of scale. They will be able to have spot monitoring. If you're a 100 percent insurer, you're the only one monitoring. If you have quality underwriting initially and you are a coinsurer, then you can do spot monitoring and depend on the other coinsurer who's at risk to do monitoring.

You can do on-site monitoring. You can put a red flag system in-place where if numbers start to come in that indicate there's a problem, then you can start exploring the conditions of those properties more carefully. This becomes a quality control problem. This approach shifts the risks to lenders where they will respond in a way that's good for the Government.

Senator GRAHAM. Mr. Lasko.

Mr. LASKO. if I could, Senator, go back to something Senator Mack was saying earlier in talking about—I think you were speculating about how an underwriter or a HUD field processor might feel with all these people looking over their shoulders and maybe that was leading to a suggestion that we shouldn't be too quick to take away from the private sector some of these roles.

Let me tell you where we are. I'll put my Mortgage Bankers Association hat back on and just note that Gaye Beasley has chaired an affordable housing task force with us for the last 2 years. She and Mr. Hipps have been very involved in an insured project committee that we've had. Let me just tell you where we are as an association representing for the most part what we think are very sound lenders.

We want to get practical. The broad picture, first of all, is to generate capital for affordable rental housing. As Gaye was saying, there really is a gap out there. While it may only be 4 or 5 percent of all the new construction, certainly it's a much, much larger percentage than HUD finances of the lower end of the new construction market and the substantial rehab market and the existing market. They are there where the greatest need is, or they should be there.

We want to get practical. Secretary Kemp said that the coinsurance program is unworkable and the regs have been proposed to shut it down. I think I can say accurately, we don't want to have an extended debate with Secretary Kemp over whether that program should be recreated. We want to get on with building and financing housing.

The framework that we seem to have moved toward—and I think we feel we had a role in suggesting it—is what we'll call a delegated processing program. I think what we've had in mind and we would love to see it move along as fast as the Under Secretary would like to see it move—is a program where, because the Department does seem interested in delegating as much of the work as possible, where the collecting of data on rents, the assembly of information on architectural and land use layouts and all the things that go into the final underwriting decision could be delegated—if we want to call that processing—to be processed by the lender.

But I think we would agree at this point with what Peter Monroe said earlier. If HUD is going to put its Government credit on the line, I'm not sure we would quarrel with its right to make the underwriting decision, the final decision, or to re-review a private lender's recommendation. But, as I say, the real point I want to make is we want to get on with it and design a workable program.

I think what you've heard a number of us come to in this is to say, by golly, it takes people and it takes the monitoring. And going back to something you said much earlier, Senator, about where did things break down, my personal view is that it broke down because, in spite of all the IG reports that were written, they weren't being read. Sooner or later somebody has to take responsibility for reading them and acting on them and they didn't. And I think you've got people at HUD now who understand that and know how to manage and run departments.

But the main thing I want to go back to in terms of referring to a delegated processing program is there's a framework there—I know we'd love to get together with you and put that into place not in 2 years but in a few months, and I think it's possible.

Senator GRAHAM. Given our time and Mr. DelliBovi's schedule, I'd like to move to the fourth question which is, what losses have been and are likely to be realized by Ginnie Mae and HUD in the coinsurance program and the related mortgage-backed securities programs, and what actions are Ginnie Mae and HUD taking, and can they take, or should they take, to mitigate those losses?

Mr. Crarėn, you made some reference to that in your prepared statement. I wonder if you could give us an assessment of your sense of what the losses are or will be under these programs and what steps are being taken to try to mitigate that number.

Mr. CRAREN. Mr. Chairman, I was disappointed to see that chart [Chart A]. I haven't reviewed coinsurance defaults lately, but they are now up to $1.6 billion. At the time we completed our audit, we recommended a reserve and FHA recorded a reserve of $960 million and we cautioned at the time that we felt that was not going to be enough because the program was flawed in enough ways that it could be much higher. I think after seeing this chart, it will be.

I think that disposing of a messy portfolio like DRG's is costly—the interest and holding costs are high—and the recovery rates are terrible. While there's a lot to be done and a lot to be said about disposing of the mortgaged properties quickly, about getting the best price, and about avoiding excessive interest costs, I think HUD is suffering a lot of losses now because of the poor underwriting in many cases. In these cases, the property was overvalued, eventually leading to low recovery rates.

So I can't give you a figure. I can certainly say that based on this chart, HUD losses could be much higher than the number FHA recorded at the end of our audit.

Senator GRAHAM. Mr. Monroe.

Mr. MONROE. I want to point out one element that is going to significantly increase the losses that the Federal Government is going to take as a result of this debacle in flow of defaulted mortgages. Our policy is for Ginnie Mae, when it receives these defaulted mortgages, to immediately assign them to the FHA. Once we get defaulted mortgages and if we can't work them out, then we have to foreclose. We either will sell them at foreclosure to a third party or we will foreclose and own those properties ourselves.

As soon as that happens, those projects are subject to the provisions of the McKinney Act, which provides that all vacant units and all units occupied by income-eligible tenants have to be held at least 15 years for low- and moderate income use. That means a choice—either a gigantic amount of section 8 funds will have to be applied to these projects or in the alternative we will have to sell these projects for a dollar, take the entire loss, and try to induce someone to hold them as low and moderate income. What's happening—and I think it was unexpected when the legislation passed—is we're allocating subsidies instead of where the need is we're allocating it on the basis of where the defaults are, often in soft markets where they least ought to go.

So I really want to just say that there's a whole thing that's going to immensely aggravate the losses that we're going to be taking as a result of this. Beyond just the natural workings of overmortgaging, there's a whole other hit because of the workings of this act and I just hope that you might, Senators, look at that.

Senator **GRAHAM**. Has the Department made any policy recommendations relative to that issue?

Mr. **DELLIBOVI**. Senator, as Peter indicated, this is something that just in the last 6 months or so that we are confronting and we are still figuring out how best to deal with that. There are several ifs in that scenario.

The properties have to default. There are a number of steps that will have to be taken before we face that, but clearly the provisions of the McKinney Act, if they were to apply—and we see no reason why they would not—would have a role. We're just not sure of the extent of that at this time and we're still evaluating that. I would describe the scenario as the worst case scenario.

My memory is being refreshed. We did include a proposed amendment in the reform package that the Secretary sent up last year. It didn't survive in the ultimate bill.

But if the staff were to examine our reform submission version the first time before the conference report, there were some provisions that we believe fix that and certainly we will be happy to supply for the record what those provisions were.

Senator **GRAHAM**. Do any of the other members of the panel have comments as to how the current situation is being managed in terms of mitigating the ultimate losses?

Senator **MACK**. Let me just ask a couple of questions before we get into that point.

Are there any details, any facts that I ought to know? One of the things in my early years of lending in analyzing financial statement, I was always told by accountants to try to look at a number and ask the question, what are the tangibles that back up that number? So what I'm curious about is what's the makeup of that $1.6 billion? What should I know about it?

Earlier we heard that—I guess going back to the $960 million figure that if we took two large lenders out, then the rest of the numbers all look good. Is there geographic concentration? I think you raised a question about the number earlier I think in the sense does it indicate only defaulted loans or is it pass-through loans and defaulted loans? Tell me a little bit about that number. There's a lot more to it than what meets the eye.

Mr. Craren. I believe those are defaulted loans, but let me add a couple of points that I think the chart understates.

First, interest is still running on many defaulted loans because the Ginnie Mae security is getting paid down gradually as the loan liquidates. The number in the chart does not include defaulted interest, which is a big part of the claim that's eventually paid. Interst costs are high because in many cases it takes a year or 15 months or 2 years to complete a foreclosure. So there's a substantial interest cost in this.

Second, in many cases there is nothing or very little in the escrow accounts. These escrows are needed, for example, to do repairs and improve the price received when the properties are sold at auction. So, if anything, I think that number in the chart might tend to minimize what the claim will finally be because there will be a significant interest and other costs incurred.

As we've seen primarily with the DRG portfolio, the rate of claim-recovery is very small. In accounting parlance, there are just not many tangible assets backing the claim, so the default losses are very heavy.

Senator Mack. Is there anything in those—and if anyone else wants to respond to that question I'd like to hear it, but the bottom line what I'm asking out of it, as we get to know more about that number, is there anything to indicate to us that there are other substantial losses coming?

Mr. Monroe. As I look over the individual default rates which I think would be inappropriate to specifically discuss, but as I look over them and leave out the ones you mentioned—14 percent, 11 percent, 15 percent—these are default rates—12 percent, 75 percent, 43 percent, 13 percent. What's happening is the default rates are rising dramatically in lenders' portfolios, not just other DRG's. It's more widespread. The default rates are rising across the board.

Senator Mack. As you go in and look at these different defaults, have you drawn conclusions as to the reasons for the default? It seems like the only thing we've really talked about is the overvaluation in the lending more than the project was valued. Is there more to it than that?

Mr. Monroe. I believe that was the primary engine of the problem was just that all the incentives were to maximize mortgage amounts and there was no check.

Senator Graham. Those are decisions that sadly have come and gone. Are there any issues before us today that could be affected that would allow us to mitigate the losses? The PW report of January indicates that we were recovering about 40 percent on the loan amount which I think you described as being dismal. I believe it's also about the same level of recovery that the RTC is getting, as an unsecured creditor, against thrift institutions.

Mr. Dale. Senator, if I might, it seems to me there probably are some things that could be done today that might help mitigate those numbers.

I think Peter pointed out the first one. I would suggest that there are some defaults that are occurring because the borrower community is not ignorant of the 1987 legislation which affects the FHA insurance programs—not just coinsurance—it dealt with the full insurance programs which includes co-insured loans when they come back to FHA through Ginnie Mae. The borrower community is familiar with the legislation which makes the FHA one of the easiest mortgagees to negotiate with, only because they have such horrible things happen to them if they actually take title to the property, in terms of their ability to dispose of it. So I think there may be some legislative action that could help stem the tide, if you will, of some future defaults.

More importantly, in a problem loan situation, the most aggressive possible asset management is absolutely essential. You can lose money very quickly by letting the problem fester. Unfortunately, we have had a few problem loans that came out of our mid-1980's Texas experience, and we have found an aggressive management posture is essential. Upon default, we immediately go into court to seek control of the property. We collapse a security as quickly as possible, if there is one, so that we stop making interest payments every month. We aggressively manage the property and pursue getting clear title. This is often very difficult. Here is another area where some legislative efforts might be appropriate. I know some changes in bankruptcy, laws have been suggested by the Mortgage Bankers Association, among others. Under current bankruptcy laws, many borrowers are just playing for as much time as possible before foreclosure. Throwing a single asset prtnership into bankruptcy buys them an extra 12 months—and one more tax year—if nothing else. Frivolous bankruptcy filings are costing lenders enormous amounts of money, and I believe this could be legislatively controlled to some degree.

So it seems to me a combination of a couple of legislative actions and some very aggressive asset management of problem loan portfolios could probably save the Government a considerable amount of money with this portfolio.

Senator **GRAHAM**. Ms. Beasley, did you indicate that the MBA has some recommendations on that bankruptcy law reform?

Ms. **BEASLEY**. Yes, we do, Senator.

Senator **GRAHAM**. I wonder if you could make that available. Is it in the prepared statement?

Ms. **BEASLEY**. It is, yes. Following up on what Larry said, I think the bankruptcy laws for single asset borrowers using FHA insured loans, legislation needs to be in place because what has greatly exacerbated the number of coinsurers who have defaults is the cash flow problem of carrying those loans for sometimes 2 years through the bankruptcy courts and into the claims procedure.

Aside from legislation, though, I think there are three things that HUD could do or three goals that HUD should look at in order to minimize the losses.

The first is I think they need to keep the originating lenders, the coinsured lenders, actively involved in those portfolios, in servicing them and in workouts because once those loans go back to HUD and are monitored by an insufficient staff, the losses are going to mount dramatically.

Second, I think they need to have financing available for loans that are sold in foreclosure. One of the reasons that the loss severity rates are up so high is that financing isn't available for people who want to acquire the property at foreclosure. Therefore, you are getting numbers that are much more dramatic than they would have been in better times in the capital markets.

Third, they need to keep flexibility in the program for mortgage modifications and for operating loss loans. Now all three of those things could be accomplished with some legislation, but primarily within HUD, if a conversion to full insurance of those portfolios were enacted by HUD or accomplished by HUD. The full insurance thing gives us more flexibility to work out losses. It gives us more flexibility for mortgage modifications and it will keep the coinsurers in many cases out of corporate bankruptcy and enable them to continue to service the loans.

The industry is negotiating with HUD now on a price. Nobody is asking for a free ride here. But I think that is going to be essential to minimize those losses in the future.

Senator **Graham**. Ms. Beasley, could you restate your third recommendation to HUD?

Ms. **Beasley**. They need to have flexibility for mortgage modifications and they need to have operating loss loans available for these projects. They are available now for loans that are fully insured by HUD. They are not currently available for loans that are coinsured. Therefore, the coinsured loans need to be converted to full insurance to avail themselves of those remedies.

ROBERT P. KALISH, EXECUTIVE VICE PRESIDENT, GOVERNMENT NATIONAL MORTGAGE ASSOCIATION, WASHINGTON, DC

Mr. **Kalish**. Senator, I would just like to add one point to Mr. Dale's comments and I agree with them. Ginnie Mae now holds the portfolios of five defaulted coinsured lenders that are serviced by subservicers under contract to Ginnie Mae. The subservicers work very, very hard in order to try to bring defaulted loans current.

One of the problems they are having, as Mr. Dale indicated, is many of the owners are now aware of the fact that by not making their payments they can in fact get a better deal because Ginnie Mae will assign, if we cannot bring the loan current—will assign the mortgage to FHA where they think they can get a better deal. And in some cases we are able to work out some defaulted loans. Recently in Georgia, through a restructuring of the debt, we were able to save $50 million in defaulted loans. But we are being faced more and more with the problem Larry mentioned, that the owners are just saying, hey, why should I bring this loan current; if I don't, you will assign it to FHA and I'll be able to get a better deal.

Ms. **Beasley**. It's reverse leverage. The borrower has leverage over the lender at this point.

Senator **Graham**. Could you flesh out what the borrower's mentality is that leads him to feel that he's going to get a better deal with FHA? Is it the McKinney Act issue or is it more than that?

Mr. **Kalish**. Well, in a way it is the McKinney Act because they know HUD has very limited and thin resources to comply with the McKinney Act and therefore may go a little bit beyond what would have been considered reasonable a few years ago in keeping the owner in place. The avoidance of having to acquire the project through foreclosure, at least in the owner's mind, creates a perception that, in effect, I can dictate the terms to HUD, whereas before I couldn't. I know HUD doesn't want to take this property back, so maybe they will take a dollar down and a dollar a week for the next 20 years.

Ms. **Beasley**. It's compounded, Senator, if the loan is still in the portfolio of a coinsurer. The borrowers know that the coinsurers have no income stream now to carry the interest on those lost loans. They know if they throw it into bankruptcy they can take 18 months or so and the borrower will be just bleeding trying to carry that loan for 1½ years and then once the coinsurer assigns the loan to HUD it may be 6 months before their claim is paid. So they know that a few defaults will devastate almost any of the coinsurance companies and therefore they believe that they have the upper hand and, in many cases, they do.

Senator **Mack**. Following on to Senator Graham's question, I'm still trying to figure out where does the borrower think that he or she will be a year or 1½ years from now by playing this game? What's their end game? Can you use maybe an example because I'm having difficulty grasping this.

Mr. **Hipps**. If I might interject something on that line, this phenomenon is not new to HUD or FHA, this game of borrower versus lender versus FHA has been going on for the 20 some years I was there. It has been exacerbated seriously by the McKinney Act because of the position that HUD has been put in by further tying their hands to deal with the properties once they acquire them.

The general view in the owner or borrower community has been that you can cut a better deal with HUD when it comes to a workout than you can with the private lender. Therefore, the game used to be—and I presume still is—when you really get yourself into financial trouble, the way to hang on to the property is to get it into HUD's hands so that you can work out a much more favorable workout arrangement than you might otherwise be able to do.

Now admittedly, HUD's policy on workouts got much tougher in the 1980's and I can't speak to the situation now, but this is not a new phenomenon.

Mr. **Dale**. The policies got tougher, but the flipside is that the consequences of HUD taking title to a project through foreclosure got worse for HUD in early 1987. So that's sort of an offsetting phenomenon. I guess the one thing that I would add to George's comment is that in the worst case, borrowers go through 2 or 3 years of negotiations. If they ultimately fail, most borrowers have taken tax losses during that time and deferred the tax recapture that occurs upon a foreclosure for several years. So in the worst case they are forestalling a tax bill for 3 years which is worth a lot of money in and of itself.

Senator **Graham**. Do you anticipate the decision to terminate coinsurance will have any effect on the future status of loan defaults? Are those in any way likely to be linked or are they isolated events?

Mr. **DelliBovi**. We don't believe there will be any increase as a result of that. However, there are going to be more losses than have been booked. It's very important that everyone understands that. If we kept it going, if we closed it down, we would still be getting hit with losses as a result of previous delegated underwritings and those deals are still going to come back at us.

Mr. **Monroe**. If we had kept it going, it could have provided the same perverse incentives that we've seen with other large coinsurers who went into default—where they struggle for these fees and they have to overmortgage in order to get them and then they use those fees to cover the losses on the projects that are already there so that they can stay in business, thereby deferring their own default just a little bit, but on the other hand creating yet another bad mortgage for us to deal with. It might speed up the default process a little bit. I think it's worth the price.

Professor **Edelstein**. I think to get an accurate evaluation of where you stand, I think there has to be some notion on what percentage of properties have values that are greater than or equal to the loans outstanding. Is there any type of estimate that you have on what exists? Unless you know that, that's what your collateral is and that gives you easy leverage. The rest of them become hard leverage and the value is not sufficient. Do you have any numbers?

Mr. **Monroe**. When this administration arrived, we discovered that there was fundamentally no information whatsoever with respect to the status—the asset quality, if you will—of the projects underlying these mortgages. So one of the things that we did right away was to come up with a system to go out and get information on these projects, which is very time consuming, and we've begun to get some pretty good information. As that information came in, it was alarming because we saw how many projects really were in difficulty that hadn't yet registered as defaults. When we saw that and when we also adopted basically a postcommitment monitoring system whereby after each mortgage came in we checked to see whether or not the mortgage made sense, we saw that we were still having problems. Then we saw the defaults begin just to shoot up. That was a big part of our decision to terminate the program—going in there and finding the asset quality, how many of these projects really are worth the mortgage—and the numbers were alarming. We still don't have all the information. One of the large coinsurers hasn't yet given us that information and we are struggling to get it. But there are thousands of projects.

Mr. **Craren**. I would just add, one of our concerns is that HUD only did the rudiments of the system looking at asset quality, which is all they could do. That system is nothing like a call reporting mechanism, or a group of supervisors gathering information and doing risk ratings on loans, or doing a shadow loan loss investigation, any of which would provide better information about the value of the collateral. HUD couldn't because that would take some time to develop. They did put the rudiments together, or tried to, but I think your point is well taken.

One of the problems we had performing the study, was that we didn't have information about asset quality that we could get our arms around and say, yes, that's something we can use to do a reliable study on and give you an idea of the financial status of the fund. That was a very big problem for us and I think for HUD.

Senator **Graham**. I'm sort of drifting back to some of the earlier questions. We are now at noon and I know that some may have to leave and we thank you for your participation.

I go back to that question of who should have known that these problems were on the horizon, when should they have known, and what should they have done? That's a question that I would like to ask at several levels, starting with the people most directly involved with the structuring and subsequent implementation; then at higher levels within the Department of HUD who had responsibility for general oversight; the IG's office, sort of an inside-outside viewer; the Office of Management and Budget or whoever in the executive branch has general oversight of executive programs; and then finally the Congress.

What comments do panelists have about the systemic lapses that let a program that apparently had so many flaws get so far down the runway or into the air and now we're at the adjacent cornfield picking up the crash pieces?

Senator MACK. Don't everybody jump in at the same time. [Laughter.]

Mr. DELLIBOVI. Senator, at which level do you want to start?

Senator GRAHAM. Let's start at the point of impact, at the beginning. What have we learned from this experience in terms of the hands-on units within HUD?

Mr. MONROE. We need good management information. We need good early warning systems. We learned that it was very valuable to review these commitments after they were done to see whether or not they made sense. We learned that it was important to have information, as Tom said, on asset quality so that we could see these things coming and begin to anticipate and change our policies. In fact, that's why we're reorganizing within housing to set up an office of evaluation that will do exactly that. It's going to combine information systems and program evaluations so that we can move more quickly.

Most importantly, we should have read the IG reports and I do read the IG reports, but historically I think perhaps the IG reports weren't adequately read. If they had been read and acted upon, certainly situations such as the DRG situation wouldn't have been allowed to become so significant. I would think that Mr. Greer would probably have a lot of insights into what we might do.

Mr. CRAREN. Let me just make one more point. And we made this point when I testified with the Comptroller General. There were no financial audits of FHA. Those audits would have presumably gotten in and started reserving for these losses, and then presumably either on the oversight committee or GAO would have said, "That's too big. That's not what we bargained for with this program." This information was missing completely.

I think the Comptroller General and we recommended that there should be yearly financial audits of the FHA which I guess was in the HUD reform bill, was it not? So I would point the finger at yearly financial audits as one way of at least detecting that there is a problem.

Senator MACK. I keep coming back to, Al, you saying that given as you analyzed what went on with respect to the incentives to different people to do wrong, if you will, that that program if it had been over in Transportation would have been laughed out of the building.

I think the question that I keep coming back to is, at what point in Transportation would someone have identified this as being such a laughable program that it would have been terminated at that point?

Mr. DELLIBOVI. Well, I can think of any number of points, Senator, at Transportation where it would have been, but certainly it would not have—I would say at the Deputy Secretary's level. The Deputy Secretary that I dealt with most commonly then was Jim Burnley, who went on to be Secretary, as you know, and it would not have gotten out of his trap that's for sure. It would have been caught at that level.

I think even earlier on—the structure of the two departments is different, but I don't think it would have made it past the Assistant Secretary level because the analysis would have been done. This frontend risk analysis process that we've put in place now was a concept that Secretary Kemp and I had. We put it in place and right now we don't even deal with the mechanics of it. I know that it's working only because the IG and the Assistant Secretary people tell us. Well, we had a great idea but that went out the window.

When you do this right, the great ideas get punctured at the earlier stage. You don't get down the runway, to use the chairman's analogy, very far and you certainly don't get into the cornfield. It requires a sort of collegial attitude within the management style so that the IG is not looked upon just as an inspector but also someone you can send a concept over to. I'm sure that—and I can't speak for the IG's and you might ask Mr. Greer—but I doubt that too many ideas were sent over beforehand to the IG. We've worked with them and had them on the team and certainly not coopted them, but when we have a suggestion, a solution or a fix, we send it over there and we do it early on because we believe that they are in the field and they have watched most of these ripoffs over the years and they have the expertise and the knowledge of knowing every which way these programs have been perverted, and we think it's good input.

Also, talking with the industry as well.

Senator MACK. So your point is that this thing was—it should have been stopped before it even came out of discussions at HUD?

Mr. DELLIBOVI. I make that point but I'm smiling because my secretary constantly reminds me that it is very easy to quarterback on Tuesday and Wednesday mornings, but we are keenly aware of the fact that it is easy to quarterback after the game. But we still believe that there's opportunity for time-outs along the way to deal with these corrections.

Senator GRAHAM. But if you line up the local Little League team to play the New York Yankees, you are not going to be very surprised even on Monday as to what the result of Sunday's game is.

Mr. DELLIBOVI. That is absolutely correct.

Senator GRAHAM. One thing that has been a theme throughout our hearings has been the layering problem. That is, one program isolated in itself may have been appropriate and appropriately directed towards the goal of providing that additional increment of public subsidy necessary to make these transactions economically viable. But then you had third, fourth, fifth levels of layering which ended up in unjust enrichment.

In this case, it seems as if you had various parts of HUD that who got involved in this and an idea that started off as privatization and sharing the risks. By the time you ended up putting all the boxcars together, you had a train in which there was no sharing of the risk and in fact what's been described as some perverse incentives that actually increased the risk.

What comments do panelists have about the role at the Secretarial level of providing that umbrella of assessment of all the things that are collectively impacting on this transaction and whether in the aggregate this is acceptable public policy?

Mr. DELLIBOVI. The layering issue I think dramatically illustrates what happens when nobody is watching the various levels of the subsidy that are being put into an endeavor.

Again, I frequently use the comparison between the two departments on 7th St. because I've been in both of them. At Transportation we were always looking at the output that we got in terms of the input—the dollars that went into the projects. Both of you are very familiar with the Transportation Department's views on the Miami Metro project, which I will not deal with here, but suffice it to say that the Department of Transportation does rely and the transportation community does rely on those kinds of measures—cost effectiveness.

It seems to me the housing programs do not measure cost effectiveness. We look at a result that we want and we all want that result and then whatever is thrown into the mix to get it we may be paying far more in public resources than we need in the layering of the subsidies with the low-income tax credit was the quintessential example of that problem.

Senator GRAHAM. Let me move up a level—before I move up, let me make a lateral move into the IG's office. Are there any comments based on this experience in terms of how the IG's office performed and what it would need to perform in the future?

Mr. GREER. As several people have pointed out, our internal audits over the years pointed out both what I would call the structural flaws and the thing I mentioned earlier, the inability of HUD, if you will, to manage the program and to monitor it, to develop financial systems to do the types of early warnings that Peter and Al mentioned are essential to any Federal program.

I think you have a scheduled hearing later this week or next week on basic management controls and I think if I could sum up our experience with this program they simply weren't there.

I think it might be a useful exercise, as Larry Dale was talking, I took notes on the things that he said. He said you needed to have capital and monitor the capital. You need to have a third party account where the capital was put off and made available to HUD. You need to underwrite to value. You need a fee structure that differs. It has to be skewed to the back end, not to the front end. The incentives have to be to write good loans, not numbers of loan. You have to have good management and monitoring is essential.

And one of the things that Al DelliBovi pointed out and it's absolutely true, since that group came to HUD, the enforcement actions taken by this administration is the difference between night and day as to what was done in the previous administration.

And the last point I picked up on was this notion of a franchise system which, if you're going to have any delegation of risk-sharing, you need to have that firm or individual have a vested interest—that is, the franchise. If he has that vested interest, then he's going to deal with you fairly and honestly and do a good job for you.

With that in mind, I would just point back to 1983–84 and say that very few of those essential items were in the program and I believe they will be designed in any new program.

Senator **GRAHAM**. When I was back in Florida, we had an inspector general system and part of that system was that the head of the agency that received the IG report was conducted was required to, within a stipulated time period, give a written response to the items raised in the report, an indication of where there was a disagreement or, if there was agreement, what action plan would be taken to rectify the identified problem.

That report was then made available to the legislature and other interested parties.

What is the system within HUD or IG's generally in the Federal Government relative to followup on your reports?

Mr. **GREER**. Let me try to explain it because it operates at two different levels. When we issue an internal report, in this case we would have issued the report to the Assistant Secretary, not to Secretary Pierce. And it would be the Assistant Secretary's responsibility to review that draft report and make any comments that they care to make on the report.

As we point out in Mr. Adams' statement that was presented to you in September, oftentimes during the course of the audits that we did in this program, the first one we did there were no significant defaults. So basically management told us that absent some demonstrable effect that they did not consider the type of things that we were suggesting to be all that important.

In 1988 when we issued our second report, once again the Assistant Secretary level said to us in response to our draft report—and this time there were considerable defaults and even losses—that the types of things that we were suggesting and some of those in the list that I just went over would absolutely kill the coinsurance concept and that coinsurers would not operate under those constraints.

When the new administration came in, they took another look at that report and have worked towards where we are today. First of all, trying to fix the program and finding it not fixable, then going on to something new.

The second part of your question is on a 6-month basis on a semiannual basis, under the IG Act, we are required to report to Congress. So we summarize what we have accomplished over the last 6 months, present that report to Secretary Kemp. He has 30 days in which to submit it to Congress.

Senator **GRAHAM**. So the fact that you were making these reports to Assistant Secretaries, identifying problems such as you indicated you did in your second report, all that information was made available to the Secretary and to Congress?

Mr. **Greer**. Yes, sir.

Senator **Graham**. Including the fact that no action was taken based on the defects you found?

Mr. **Greer**. Yes. That's another requirement of the IG Act is when we have significant recommendations and we're not satisfied with the action taken, we are then to report that again to Congress and as an appendix at the end of the report that accomplishes that.

Senator **Mack**. Just to be a little bit more specific, when you say you report to Congress, do you report to a specific committee in the Congress? Who gets that report?

Mr. **Greer**. That's interesting because we found over the years that very few people got and read our reports, although they were sent to the various subcommittees. Whether they are read or not is a matter for debate at this point.

Senator **Mack**. So your report would have gone to the subcommittee of the Banking Committee dealing with housing and urban development?

Mr. **Greer**. Yes, sir. What we try to do now because of the problems that have arisen is in our most recent 6-month report we arranged for and had briefings with staff. Many of the staff that are here attended a briefing the day that report was issued. We briefed staffers on both the House and the Senate side.

Senator **Mack**. Again, from your perspective, at what point did you first raise your concern in a report that ended up in the hands of, let's say, the subcommittee? When was that? 1987, 1986, 1985, 1988?

Mr. **Greer**. I think it was in 1986. We issued a report in the fall of 1985 to the acting Assistant Secretary, who was Janet Hale at the time, and that report was issued to her but reported to Congress a few months after that. So it would probably have been in 1986 the first time. But that was the report where we had looked at about 20 loans and there had been no defaults or losses at that point in time.

Our basic finding then was to go back to the monitoring and enforcement was not being done.

Senator **Mack**. So probably the typical reaction up here was one of, while we see maybe some technical problems in a sense that there's not enough monitoring in place, there is really no red flag in the sense that there are loans out there that have defaulted. And it wasn't until the following report which would have been in late 1986 or early 1987?

Mr. **Greer**. The second report was done in December 1988.

Senator **Mack**. OK.

Senator **Graham**. Mr. Dale.

Mr. **Dale**. A couple of things I was reminded of. First, there were two phenomenon that occurred in the mid 1980's that may help explain the 1985 report that showed no loan defaults and what we're experiencing today. Virtually any active income property lender that was in business through the 1980's would look back at their portfolio and have some significant questions about its performance. Indeed, if you read the headlines today, you can see almost everyone is doing just that and wondering about their portfolios' performance.

First, the phenomenon that occurred in the Southwest was indeed a depression in a major region of the country. The combination of overlending by thrifts and a severe economic depression made good quality income property lending in the Southwest extremely difficult to do. Anybody who was in that business at all—and I indicated earlier that we were in the business and we have taken some lumps from that business—took a fair amount of lumps from that business.

Second, the Tax Reform Act of 1986 did indeed take substantial value away from income property, including apartments across the country.

Now I say both of those things not to suggest that they are an excuse for coinsurance. It's certainly not. The losses are much more dramatic and much more severe than I think virtually any other lender in the business has experienced. But I would suggest that we would probably be having some discussions—albeit at a lower level of volume—even if coinsurance had been run perfectly from the outset with 20-20 foresight. We would probably still have some losses and some questioning about whether it was done right at this point in time.

I guess the other point that I would make is more philosophical. It seems to me that it is difficult enough for the Congress to enact good legislation. It is almost impossible for you to enact laws that require good administration. Indeed, the attitude that existed between HUD and the Congress in the 1980's was adversarial in the worst way. The administration was doing almost anything it could to find its way through that maze and do what it wanted to do—which was in almost every instance opposite of what the Congress was telling it to do. That resulted in a whole lot of mismanagement or administrative decisions and other things that were out of sync with maybe what should have been done or at least with what the Congress was hoping would be done. I think that attitude pervaded the better part of the 1980's.

It also had an effect on—and this is from anecdotal information—the morale and feeling of career staff at the Department. Everything that came out of the administration was negative concerning the programs that they were involved in. I think there were a lot of folks at the Department at the career level who said, well, let's hunker down and keep our head down and hope that we can survive this, as opposed to making sure that something positive came out of the program. They were not genuinely appreciated and that was made clear from all of the statements made by their superiors.

Senator GRAHAM. I'd like to come back, when we get to the level of what should the Congress have been doing or what should it be doing to raise that issue, how does Congress appropriately act in a circumstance where it has a different policy perspective on programs than the administration? What are its responsibilities vis-a-vis the appropriate management of those orphaned programs?

Ms. BEASLEY. Senator, I would just like to add to Larry's remarks. With one or two exceptions, I think most of the coinsured lenders were working conscientiously toward building good portfolios of value and also you have to remember they had, if they built a value in their portfolio, they had an ongoing income stream through mortgage insurance premiums and so forth. But these were trying times for all lenders and the inflexibility of the coinsurance system I think exacerbated the losses.

I think as this committee goes forward and tries to look at new housing programs and new ways to design a delivery system, it's important to have the full picture and I, for one, would really like to see under the claims paid number on this chart the amount of MIP's already collected by HUD and the amount of MIP's projected to be collected by HUD so that we had the whole picture when you look at losses and claims and I think that would better enable us to deal with delegated processing.

Senator **Graham**. MIP is mortgage insurance premium?

Ms. **Beasley**. Yes, sir.

Senator **Graham**. Those of us who are lay people in this are always going to have to impose a prohibition on the use of acronyms here or we will be even more at sea.

Let me ask about the next level and that is the White House and the OMB. What role does the executive in the broadest sense have in terms of overseeing the management of the line agencies and what in fact occurred from your perspective vis-a-vis this particular program and executive oversight?

Mr. **Hipps**. I guess I will attempt to answer that. I'm not sure I can.

OMB is always that great specter to somebody in the Executive Branch. Trying to relate what role OMB may have played in coinsurance, I am not personally aware of any real role they played other than the traditional role of reviewing and approving for publication the regulations that implemented the programs.

All of the analyses were made available, I'm sure, to OMB, along with the proposed regulations and those regulations were I presume examined and found to be acceptable to them.

But I can't state as to what depth they may have understood the process or understood what potential there may have been there for risk because the examination is, after all, done by budget analysts, not by people who have any great breadth of experience in housing programs or real estate in general.

OMB plays a different role at different times. It depends on how badly they want to do things. I would reiterate that I think we make too much over any idea that coinsurance was a great scheme or that this was a great effort to privatize. At least I don't see it that way.

I think that privatization happened to be the buzz word at the time, but that coinsurance was the statutory vehicle that HUD had available to it at a time when it was interested in finding ways of coping with workload, with a diminishing staff, and that it became the natural vehicle. Accidentally, it was privatization as the term was being used during the 1980's, but that was not the driving issue. The driving issue was tremendous pressure from the industry at large—borrowers, lenders, everybody—that HUD offices were not responding in anything close to a responsible timely manner generally. There are always exceptions.

And it was in that context that coinsurance was used as a vehicle.

Senator **Graham**. The MBA surfaced some of these issues in the 1985-86 time period and I believe had some direct contact with the Secretary of HUD.

Did you make your concerns known at the White House or to Congress?

Mr. **Lasko**. No. At that time the president of MBA—in the summer of 1986—wrote a letter to Secretary Pierce expressing concerns about the high delinquency rates in the coinsurance program and I was there at the time at MBA. I think we felt that was the appropriate avenue, that the Department administered the program and we knew the Department at the time was looking at DRG and they were the decision makers.

Senator **Graham**. Since we discussed acronyms, that is the name of a mortgage company that was involved in coinsurance. The letters happen also to be my initials. [Laughter.]

If we could turn to the role that Congress played, what should Congress have been doing during this period to have been more participatory in this process? I guess we could have started out by reading the inspector general's report.

Mr. **Craren**. Again, Mr. Chairman, in my involvement with the audit, the idea was to have at least an annual oversight hearing after the audit is released, and we suggested that earlier, much like an audit committee would function for a private company. For example, the oversight would be to ask questions at the hearing and then perhaps that would serve as the lead for the committee to get into more details about particular problems.

Senator **Graham**. Again, going back to my previous life, we used to try to identify what we thought were the essential management issues within a department, such as how many miles of highway did the DOT maintain or whatever was appropriate, and then a data base that would give us some assessment of how that management function was being carried out and use that data base as our essential monitoring tool.

What would be your thoughts as to the feasibility of applying that kind of a system, not to micromanage but to get some macroassessment of the general health of the department of the executive branch which was operating to carry out congressionally established programs as a means of Congress taking that periodic state of the health of the department?

Mr. **Craren**. I would encourage that. I think the financial statements are just one part of oversight. I think you raise a very good issue. You have one FHA fund hat has to be self-sustaining and others that have a social purpose and you don't want them to lose excessive amounts. But I think information in terms of how much housing was produced by the amount of money invested would be useful and I think what you're really talking about is a comprehensive annual reporting process of which the financial statements are a part.

But also, an annual report which indicates how well the agency has fulfilled its mission in some quantitative fashion. I think there's a lot of merit to that and I would like to see—I was involved at GAO for a while and I would like to see other agencies move in that direction as well. So I think that's a good suggestion.

Senator **Graham**. If that suggestion had been in effect 5 years ago, what data would you have recommended that Congress ought to have been monitoring in the coinsurance program as a means of assessing its status?

Mr. **Craren**. I would be speculating. I would say, we talk about asset quality and credit exposure and things like that, but if there were some means of classifying those assets into degrees of exposure, whether it was a substandard credit, for example. I don't mean to get too much into the bank regulatory scheme, but it seems to me that program was designed to take risks that the private sector wouldn't entirely take on their own. It also seems to me that you want those risks not to be excessive. So Congress ought to know the degree to which you are taking risks and where you're taking them.

It seems to me you could have information, geographical information, perhaps some indication or some scheme of rating the quality of the assets with the recognition that you will take some risks because that's what the program was meant to do.

Senator **Mack**. Is that the kind of reporting system that should be internal in the sense of the information that HUD would develop and report—I don't know whether it would be to the Office of Management and Budget or to the Secretary—and then be made available in some form of an audit report? I like the idea.

Mr. **Craren**. Or an annual report. Because of the amount of detail needed, I think that's something the Department would have to prepare internally.

Senator **Mack**. Then the Banking Subcommittee on Housing would in essence like that auditing committee of a board of directors and review what suggestions have been made, what action had been taken to respond to those suggestions?

Mr. **Craren**. That's correct. It seems to me, and based on what I've heard in other hearings, that you want some comprehensive basis to judge not only financial management but also how well the agency is fulfilling its mission in some quantitative fashion. You could arrive at an annual reporting concept that would do both and at least give you the ability to start asking questions about particular areas.

Mr. **Greer**. Senator Mack, if I might, I believe there's a bill in Congress now to create chief financial officers in many departments. We at HUD happen to be doing that right now, but I think Senator Glenn is sponsoring a bill for chief financial officers and that may be a vehicle to accomplish some of the things that Tom just mentioned that require certain types of financial reports, although there are so many variances in the various Federal agencies I think you could establish some parameters that you would like to hear about.

Senator **Graham**. I think Mr. Craren was going beyond traditional financial reports to what I call effectiveness reports. What is the reason that you're in this program in the first place, i.e. to increase the availability of affordable multifamily housing. So how are you impacting on that objective and what is the cost effectiveness of that impact——

Mr. **Craren**. What risks are you taking and do you want to risk that much money if that's what you think the probable losses are going to be for that purpose—is that the investment you want to make? I think that's an example of the unknown I've often seen. FHA and its MMI fund is simple. It's a bottom line organization. It's a traditional financial measure. When you get to an appropriated fund it is more complicated; how do you know how well an appropriated fund is spending its money and if it's accomplishing its goals. Based on the information you have now this determination is difficult because it comes in so many different pieces and from so many different directions. You can't make that judgment.

So I don't think there's anything out there now, Mr. Chairman, I don't want to mislead you, that there's something on the table and that these things could be assembled. I think there's a lot of work to be done. My own opinion is that it ought to be done. Accountability should mean more than just a bottom line measurement for a fund that isn't really judged on that basis.

Senator GRAHAM. And one of the complexities that you have here, a question that has been running through my mind, is that, if you start off in 1981 with the idea of discrediting affordable multifamily housing, how would you have gone about accomplishing that objective? And I think that the Pierce administration took about as effective a strategy to accomplish that objective as you could have constructed.

You have that tension within our system of government with a division between the legislative and the executive branches. What do you do when they disagree as to the social utility of ultimate objectives? The Federal Government's role in multifamily housing is one example of where we had such a disagreement. If you had a parliamentary system of government, that wouldn't happen, but that's a recurring theme in ours.

Under those circumstances, what is the role of the legislative branch in its monitoring and does it require a different style than where essentially there's agreement as to purposes?

Mr. CRAREN. I have seen facts twisted so many different ways. That seems to me to be a big problem. It seems you can make your case depending on how you present the facts and how economical you are with the truth.

So I guess what I'm suggesting is some standard way, independent way, of just presenting what the facts are and then let the policy debates be whatever they may be. I don't know if that's possible. Maybe it's a pipedream, but that's what I had in mind.

Senator GRAHAM. Well, I'm going to conclude with what is reported to have been the opening statement that Chairman Alan Greenspan made as he started the Social Security Commission which led to the 1983 report and that was that everyone who is a member of the commission was entitled to their opinion, but no one was entitled to their own facts.

What we're trying to do is to get some basis of commonality of the facts upon which we can then have a good constructive difference of opinion as to what those facts mean.

I want to thank you all very much for your participation here today. I know this is a different format than most of us are used to, but Senator Mack and I had such a good experience with this format a few weeks ago that we thought it was appropriate and I think that the cross-discussion and questioning helped to illuminate some issues in a very valuable way.

Senator **Mack**. Thank you for your participation. I thought it was very helpful and I think the kind of dialog that we were able to develop was most helpful. I appreciate your participation.

Senator **Graham**. The record of this hearing will be held open if anyone wishes to make any further statement, submitting their own facts or opinions. All of the statements which were previously submitted will be included in the record.

It may be that we might have some additional questions that we would like to ask of one or more of you and we would appreciate your willingness to accept those additional intrusions on your generosity. Thank you very much.

[Whereupon, at 12:35 p.m., the hearing was adjourned.]

[The complete prepared statements of the witnesses follow:]

STATEMENT OF
GEORGE O. HIPPS, JR.

before the

HUD MOD REHAB
INVESTIGATION SUBCOMMITTEE
OF THE
SENATE COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS

Hearing on

HUD's Multifamily Mortgage
Co-insurance Program

Mr. Chairman, members of the Subcommittee, my name is George O. Hipps. I am currently a Senior Vice President of PW Funding Inc., a New York City-based mortgage banking concern. PW Funding is an FHA-approved mortgagee of some 18 years existence. We are an approved HUD Co-insurer and an underwriter and servicer under the Delegated Underwriting and Servicing program of the Federal National Mortgage Association. I am also a former official of the Department of Housing and Urban Development, having served with the Federal Housing Administration from 1959 until late 1983. As you have requested, I have identified in the attached schedule the various capacities in which I served at HUD during the period from 1974 until my departure in 1983.

I have been asked to address some of the issues and decision-making that may have been faced by HUD as the concept of co-insurance, a delivery system for FHA mortgage insurance programs, was being developed and put in place. To the extent my memory permits, I will attempt to venture into co-insurance was in its single family program under Section 203(b) of the National Housing Act, as amended. My recollection of that event is vague, though I do recall several meetings with representatives of the Mortgage Banking industry in which opposition to the concept was clear. That opposition, as I recall, was based on a view that such a program was not then necessary, because of a general view that processing times for single-family mortgage insurance were still acceptable, and because of concern that any assumed co-insurance risk would have significant adverse impact upon their lines of credit due to the perceived accounting treatment of the contingent liability.

During the 1970's, negotiations also were undertaken between HUD and the State Housing Finance Agencies toward the development of a delegated processing system using the concept of co-insurance. Numerous meetings, at both the policy and technical levels, occurred between representatives of the State HFA's and HUD in developing a program and the operating regulations. This effort led to the adoption of a final rule for a co-insurance system for State Housing Finance Agencies in the fall of 1980. This program was limited to projects wherein twenty percent (20%) of the units were assisted under Section 8, or some similar program, or to projects in Urban Development Action Grant areas.

This effort was followed by the adoption of regulations implementing a co-insurance system for the processing of loans given to refinance, or to finance the purchase of, existing rental projects pursuant to Section 223(f) of the National Housing Act, as amended on July 2, 1980. This delegated to private mortgage banking companies the preponderance of traditional FHA underwriting functions in exchange for their agreement to assume a portion of the risk of loss historically insured against by the FHA. The initial venture into the multifamily co-insurance concept with private lenders was limited to 223(f) because of a belief that it was less risky and easier to develop than would be a system dealing with to-be-built projects involving construction financing.

The concept of co-insurance was later expanded to include new construction and substantially rehabilitated projects to be financed pursuant to Section 221(d)(4) of the National Housing Act, as amended, in 1984, and to nursing homes, intermediate care and board and care facilities to be financed pursuant to Section 232 of the National Housing Act, in August 1988.

HUD STAFFING

Throughout all these efforts, HUD was confronted with a deteriorating capacity to continue to perform its traditional mortgage insurance underwriting functions with its own staff. FHA, an organization that was once well-staffed with experienced technicians, was rapidly losing such staff through retirement at the same time increasing budget pressures made it impossible to hire and train qualified replacements. Against this background was imposed the broad philosophy of the Reagan years that the size of the Federal establishment should be dramatically reduced, as well as a specific philosophy that opposed any significant Federal role in providing housing and related facilities. At the same time, mortgage lenders participating in FHA mortgage insurance programs were becoming increasingly vocal in their insistence that HUD do something to improve its delivery system. This insistence was against a background of diminished HUD technical capacity in its field offices and far too many instances of offices taking 18 months or more to process applications to the point of Firm Commitment.

With all of the above, the concept of co-insurance, which was already established in the enabling statute, was a logical tool for HUD to use.

The Subcommittee has asked what human resources were assumed by HUD to be adequate to manage and implement a co-insurance delivery system. In terms of actual numbers that is a question I am unable to answer. HUD clearly believed that moving its multifamily insurance processing to co-insurance would lessen the demand for in-house staff. However, it would be unreasonable to assume the resources needed would be any less than those available at the time the decision to move to co-insurance was made. Many functions, involving the same technical skills as multifamily mortgage insurance, required, and continue to require, HUD to retain some minimum level of expertise and processing capacity.

As originally intended, the co-insurance processing system was designed to minimize the involvement of HUD field offices. Program management and oversight responsibilities were placed in the Headquarters staff. Over time, however, HUD field offices have assumed a larger role and, under current restrictions, are required to complete a full review of the co-insurer's processing prior to a commitment being issued.

In developing the program regulations, HUD concerned itself primarily with origination matters and issues related to claims and property disposition. I cannot state what actuarial studies may have been performed. I am certain that the Office of Policy Development, within the Office of the Assistant Secretary for Housing, undertook an analysis of the relative risks of HUD and the co-insurer for the purpose of determining an appropriate split of the mortgage insurance premium between the risk takers.

Oversight and monitoring was an area of concern and discussion within HUD during the development stage. The importance of monitoring was clearly recognized by the technical staff and it was the intention of policy makers to have such monitoring performed. Unfortunately, for whatever reasons, adequate staff to perform this important task was never forthcoming.

As has been pointed out in other recent hearings, HUD did not, in the opinion of most participating lenders, provide adequate oversight, nor did it act promptly to deal with obvious problems and underwriting deficiencies of some co-insurers. Concern over this administrative failure was expressed by the Mortgage Bankers Association of America, on behalf of its members, in a letter from its President to Secretary Pierce in 1986. Unfortunately, HUD did not see fit to heed the concern then expressed and continued to urge more lenders to enter the system while taking no action to address serious failures or to deal with program flaws.

Although asked to do so, I cannot comment upon what studies or review of co-insurance may have been undertaken by the current administration of HUD. Other than the reported actuarial study performed by Price Waterhouse, I am unaware of any published studies. I would point out, however, that for a period of almost a year, many representatives of the mortgage banking industry have spent countless hours meeting with HUD officials discussing potential changes to the co-insurance system. Throughout that entire period, mostly during 1989, we heard statements of commitment to maintaining the co-insurance system and to making changes necessary to have the system function effectively. In fact, as late as early December HUD officials were still publicly expressing HUD's commitment to co-insurance as essential to delivering housing programs.

Industry representatives, on several occasions, have articulated to HUD their views on what problems with co-insurance needed correction, as well as suggestions for change. It is my opinion that, at least in some instances, HUD agreed with these representations. Unfortunately, nothing was done to make changes, leading one to believe, given the recent occurrences, that no intention to correct the system was ever there.

I do believe that HUD could have made changes to the co-insurance system which would have made co-insurance a sounder system, strengthened the capitalization of participating lenders and lessened the likelihood of financial failures like those of recent months. Mortgage bankers using co-insurance made a number of recommendations to HUD for changes designed to improve and strengthen the system. Most co-insuring originators agreed there was a need to improve the capital requirements for participating lenders. We disagreed with HUD over some of the specific approaches they suggested, but not over the basic need to require a stronger financial capacity.

One of the major deficiencies in the system has been the burden placed on the co-insurers once a mortgage is in default. Where the financing involves mortgage-backed securities issued by the Government National Mortgage Association (GNMA) the co-insurer must maintain payments to the security holder, with no contribution from HUD relative to its anticipated share of the loss until such time as foreclosure and sale of the property has occurred. HUD was asked to change this by agreeing to make a contribution based on its share of the anticipated claim after the lender had expended some level of its own funds. HUD's reaction was negative.

Other suggestions for improvement have been made, but these became moot with HUD's January action.

Most importantly, HUD must improve its capacity to manage and monitor its programs. No matter what delivery system HUD uses, aberrations and abuses will be more likely to occur if the current lack of monitoring and oversight by HUD continues. I do not currently see any commitment to proper oversight. All of the changes one could imagine, including more financial strength on the part of co-insurers, will not be totally effective as long as the resources to accomplish adequate monitoring and oversight are not made available for that purpose within HUD.

You have asked for my assessment of HUD's current capacity to perform mortgage insurance underwriting functions. My view is that there is virtually no capacity within HUD to perform such functions in-house in a timely manner and provide quality work in any environment involving significant volume. Staff expertise is less today than when I left HUD in 1983 and retirement will continue to take its toll. Lack of adequate staff for timely mortgage insurance processing is not the only problem. Training resources are minimal and travel funds are inadequate, in many offices, to permit what staff there is to do their jobs in a credible manner.

We in the mortgage origination business believe the ability to provide affordable rental housing as well as healthcare facilities is in serious jeopardy. With HUD's inability to provide effective in-house processing, with the de facto shut down of co-insurance, and with no evidence that a replacement system is ready, or will be ready this year, the provision of mortgage insurance for these important purposes is in serious jeopardy. I urge the subcommittee to lend its weight in urging HUD to move speedily to put an appropriate processing system in place.

This ends my prepared remarks. I will be happy to respond to any questions you may have.

EXHIBIT A

12/02/73 - 08/15/76 -- Deputy Director, Office of Underwriting Standards

06/74 - 08/15/76 -- Acting Director, Office of Underwriting Standards

08/15/76 - 06/21/79 -- Director, Office of Loan Origination

06/21/79 - 01/26/81 -- Director, Office of Multifamily Housing Development

01/26/81 - 05/07/81 -- Acting General Deputy Assistant Secretary for Housing - Deputy Federal Housing Commissioner - (Acting Assistant Secretary for Housing)

05/07/81 - 10/30/83 -- Associate General Deputy Assistant Secretary for Housing

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Mortgage Bankers Association of America

STATEMENT OF

GAYE G. BEASLEY

PRESIDENT
PATRICIAN MORTGAGE COMPANY

on behalf of

THE MORTGAGE BANKERS ASSOCIATION OF AMERICA

before the

HUD/MOD REHAB INVESTIGATION SUBCOMMITTEE

of the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

Round-Table Hearing Discussion
HUD'S Multifamily Co-Insurance Programs

MARCH 27, 1990

The Mortgage Bankers Association of America* appreciates this opportunity to appear before the Subcommittee to discuss the Federal Housing Administration's (FHA) multifamily mortgage coinsurance program.

MBA appeared before this Subcommittee in September 1989, to explain the need for the FHA coinsurance program as an integral element in the multifamily housing delivery system. At that time, we also pointed out to the Subcommittee MBA's continuing interest in the program, including communications between MBA and the Department of Housing and Urban Development (HUD) in 1986 (Attachment A) outlining MBA's concerns about the alarming number of early defaults in the program. In the attached letter, Mr. Ron Poe, then MBA President, wrote that problems, such as unsound project underwriting and insufficient management oversight, threatened to undermine the coinsurance program unless prompt and immediate action was taken by the Department. Last September, with the hope that the program could be saved, we also suggested that attempts be made to quantify the mortgage insurance premium income from the coinsurance program, and to obtain a realistic projection of potential losses on presently outstanding coinsured loans, as well as likely projected losses on newly originated loans, once more careful monitoring procedures and underwriting guidelines were implemented.

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* The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of housing and other real estate finance. MBA's membership comprises mortgage originators and servicers, as well as investors, and a wide variety of mortgage industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, selling, and servicing real estate investment portfolios. Members of MBA include:

o Mortgage Banking Companies
o Commercial Banks
o Mutual Savings Bank
o Savings and Loan Association
o Mortgage Insurance Companies
o Life Insurance Companies
o Mortgage Brokers
o Title Companies
o State Housing Agencies
o Investment Bankers
o Real Estate Investment Trust

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The invitation to appear before the Subcommittee at this time requested that we respond to the specific questions listed below, which primarily concern industry business practices. However, many of these questions relate to the practices of individual mortgage lenders, facts which are not at MBA's disposal. Thus, these questions perhaps more appropriately should be addressed to the Department of Housing and Urban Development, which does compile industry information. (We must also indicate that we have not conducted a complete review of MBA files.) Nevertheless, we do appreciate this opportunity to comment, as requested, on historical program design features, the implementation of the coinsurance program, and possible modifications to the coinsurance program, which could have turned it into a sound, financially sufficient Federal program, helping to provide needed affordable rental housing units.

MBA currently believes that coinsurance is no longer a program that can be revived. The current environment at HUD and in the media has created a situation where the coinsurance program has received much and in many instances unwarranted negative press. Consequently, we are attempting to move forward and work with HUD on a proposal to develop a delegated processing insurance program to replace coinsurance. HUD Secretary Jack Kemp announced the development of this new program concurrently with the proposed termination of the coinsurance program. Therefore, we hope that the Subcommittee views our responses in light of current developments.

Program Design Features

The following are responses to the questions submitted by the Subcommittee. The first question deals with our general view of the coinsurance program and is addressed in the conclusion.

Capitalization Levels

2. What capitalization level has the mortgage banking industry typically maintained during the past decade? Do you expect that level to change in the foreseeable future? How?

It is impossible to generalize about capitalization levels for the entire mortgage banking industry. MBA believes that this is more appropriately a departmental question. As a matter of regulation, HUD sets capitalization levels for participants in its various programs and requires that lenders file annual financial reports with the department. Therefore, in order to participate in the coinsurance programs lenders must meet those capitalization levels. Attachment B describes current capitalization levels for coinsuring lenders.

Participant Lending Experience

3. How many of the participants in the FHA co-insurance programs began their participation as newly established businesses without prior multifamily mortgage lending operations? Very few?

To the best of our knowledge, very few of the coinsurers were new to the multifamily mortgage lending business. For the most part, program participants had previous lending experience under FHA full insurance, and some had experience with the Federal Home Loan Mortgage Corporation (FHLMC) or the Federal National Mortgage Association (FNMA) multifamily programs.

4. Did the typical business strategy and operational economics of a newly established co-insurer differ significantly from those of an established, experienced lender? In what manner?

Business strategies and operational economics of newly established coinsurers did not seem to differ dramatically from the rest of the lending community. In general, mortgage bankers were more likely than banks or thrifts to participate in the program. Therefore, those new coinsurers were generally less well capitalized than institutional lenders. Business strategies were generally similar for all types of lenders. However, in one or two cases rapid-expansion by coinsurers seemed to obscure good judgement.

5. Was it common for participants--even those that were experienced lenders--to originate loans in a company that was separate from the company that retained the co-insurance liability to HUD or to otherwise create a corporate structure that put the co-insurance liability in a shell corporation?

It does not appear to have been common for participants--even those that were experienced lenders--to originate loans in a company that was separate from the company that retained the co-insurance liability to HUD or otherwise to create a corporate structure that put the co-insurance liability in a shell corporation. MBA is aware of only one situation in which that was the case.

HUD's Risk Management of Coinsurance

6. From the inception of the co-insurance programs was it not apparent that HUD was not managing its insurance risk portfolio on an actuarially sound basis?

To the best of our knowledge, at the initiation of the program, HUD was spreading loans geographically. However, only two coinsurers were initially approved for the program, so there was a period of time in which the risk was not spread across a number of participants. Many coinsurers did express concern to HUD about the amount of time it took the Department to approve lenders for the coinsurance program, thereby creating a monopoly for two or three approved lenders. MBA also had concerns over the lack of monitoring by the Department.

7. Did participants in the co-insurance programs appreciate the risk of illiquidity assumed in

issuing Government National Mortgage Association (GNMA) guaranteed securities backed by co-insured, multifamily mortgage loans? Does this risk, when realized, create a significant disincentive for the issuer or GNMA to attempt workouts of defaulted loans?

MBA believes that, at the initiation of the coinsurance program, most of the program participants were not then very experienced in loan workouts or fully aware of the delays borrowers could cause lenders by the use of bankruptcy filings. MBA believes that the liquidity risk does discourage workouts because of the inflexibility of the HUD and GNMA regulations.

Possible Program Improvements

8. Would you have any reservations or policy concerns with HUD relying upon FNMA to assist it under contract with HUD's performance of FHA's mortgage insurance functions? Please identify those.

MBA believes that FNMA may have been capable of successfully performing such functions in the past. However, as FNMA is now managing the only consistent source of capital available on reasonable terms for financing low and moderate income rental housing, it would presently be imprudent to burden FNMA with the task of hiring and training a large staff to assist HUD. Undertaking such an effort at the present time might drain FNMA's resources from their on-going program efforts. Additionally, MBA believes that it is important to have a fully functioning Department of Housing and Urban Development to assume a leadership role in low and moderate income housing production and preservation.

9. Do you believe that HUD undertook an adequate evaluation of the co-insurance programs? If your answer is negative, please explain in what respect(s) you believe the evaluation was

inadequate.

MBA cannot determine how closely HUD evaluated the program at its initiation. In 1983, MBA supported Administration proposals to (1) eliminate the limit on the amount of mortgages that could be insured by FHA on a coinsurance basis, and (2) implement a multifamily co-insurance program. MBA support was based, in part, on the perception that HUD historically had not had adequate capable staff to administer the full insurance programs and needed help from the private sector to complete its mission.

MBA took a strong position in 1986 urging HUD to monitor the program more aggressively and act on potential abuses. If HUD had followed that advice, we would not be here today talking about the termination of the program.

10. Do you believe that HUD's evaluation of the co-insurance programs has resulted in the identification of the means available to GNMA and HUD to minimize the losses that may result to GNMA, the General Insurance Fund, or the United States Treasury from the co-insured loan or co-insured lender defaults? If your answer is negative, please explain.

MBA has not been provided with the information pertaining to HUD's evaluation, i.e. analyses, studies, reports. However, MBA has emphasized, in its meetings and communications to HUD, that careful monitoring, combined with a reasonable increase in lenders' capital requirements, would have made the program viable and would have minimized losses. Currently, HUD's major concern, both for FHA and GNMA, is what will happen to lenders and their portfolios if the coinsurance program is terminated without an adequate replacement program in place.

11. Do you believe that HUD has given adequate management attention to the implementation

of means available to it and GNMA to minimize the losses referred to in the previous question?

MBA remains convinced that HUD is still short of qualified experienced staff to monitor the program and to assist with workouts of problem loans. HUD officials have indicated this problem in meetings and in conversations. As the proposed termination of the program is presently before the full Senate Banking Committee, attention to coinsurance does not appear to be a priority for HUD's top management. We believe that attention must be paid to working out the phaseout of coinsurance and the implementation of a replacement program or HUD's losses will increase.

12. What specific actions that HUD has not taken would you recommend to minimize the losses referred to in questions 10?

MBA suggests that efforts be undertaken to establish a reasonable program for conversion of coinsurance portfolios to full insurance. A proposal currently under discussion by MBA's Ad Hoc Task Force on Coinsurance (described in Attachment C) includes providing HUD with additional loan loss reserves and the entire Mortgage Insurance Premium (MIP) on conversion to full insurance. A conversion to full insurance status automatically makes operating loss loans and other tools normally available for fully insured loans available for troubled coinsured loans which have been converted. MBA suggests that several additional changes can be implemented to stem losses in the coinsurance program. HUD can consider changing the loss claims procedure, hire or contract for a team of workout specialists to work with the coinsurer on troubled projects, and make operating loss loans and other tools, including certain subsidies, available for coinsured loans. Changes in bankruptcy laws designed to prevent single asset borrowers on Federally insured, coinsured, or assisted loans from declaring bankruptcy, and thus delaying foreclosures, would be extremely helpful.

13. What changes in insurance premiums collected under the multifamily mortgage coinsurance programs would be economically feasible in light of current market and other circumstances. To what extent would any increased premium income to FHA pursuant to such changes reduce the losses that HUD has realized or reserved under the coinsurance program?

With regard to changes to the coinsurance mortgage insurance premium, MBA believes that such a proposal is irrelevant now, given the proposed termination of the program, and the effective termination that the presently implemented precommitment review is generating. Since coinsurance has been terminated, its MIP cannot be increased. MBA would like to comment that although additional MIP clearly reduces HUD's losses, it also increases the cost of insured housing units. Thus, the tenants served by the program would have to pay higher rents.

14. What reasons explain HUD's past failure to enforce vigorously its remedies against co-insurers, which failed to comply with program requirements?

As indicated above, MBA did attempt to bring problems with the program to HUD's attention several times in the past. However, MBA cannot speak to HUD's past failure to enforce vigorously its remedies against co-insurers, which failed to comply with program requirements. It is apparent however, that there was a lack of attention to oversight and monitoring. Nevertheless, HUD has taken several actions in the past year, including suspensions of lenders, which have shown that enforcement efforts were being undertaken.

15. How would you distinguish the human resources and institutional capacities that HUD will need under a full insurance, delegated underwriting program from those HUD would need to manage properly the co-insurance programs?

Human resource and institutional capacities required at HUD for delegated underwriting should exceed those for proper monitoring and oversight of the coinsurance program. HUD has admitted that they have insufficient staff to monitor the coinsurance program adequately. They should, therefore, be asking for the additional staff necessary to provide minimum staffing requirements for the replacement program of delegated processing. Under delegated processing, HUD will be responsible for functions previously delegated to coinsurers. Therefore, additional staff and travel funds will be required in headquarters, and more importantly, in the field. Staff must also have technical expertise and the travel resources necessary to carry out their responsibilities.

Conclusion

The coinsurance program has experienced problems because of the claims procedures designed for the program, an inability to prevent some lenders from continued participation in the program, and an acute lack of experienced staff to perform oversight and monitoring functions. Despite these problems, the program did help finance over $10 billion of affordable multifamily rental housing units. At present, there is no financing program to meet that market niche, and a development of a replacement program should be a high priority for the Federal government.

MBA hopes that the Subcommittee finds these comments useful, and encourages HUD to implement these recommendations.

Attachment A

1125 Fifteenth Street, N.W.
Washington, D.C. 20005

Mortgage Bankers Association of America

Ronald F. Poe, CMB
President
(202) 861-6500

July 8, 1986

The Honorable Samuel R. Pierce, Jr.
Secretary
Department of Housing and Urban Development
451 Seventh Street, S.W.
Washington, D.C. 20410

Dear Secretary Pierce:

I am writing on behalf of the Mortgage Bankers Association (MBA) to express our grave concern with the continued operations of the Multifamily Coinsurance program. Since 1983, when the Department of Housing and Urban Development (HUD) unveiled the 223(f) Coinsurance program for existing apartments, a number of problems have surfaced involving unsound project underwriting and insufficient management oversight which have been documented in a HUD Inspector General's Report dated November, 1985. These problems now threaten to undermine the Coinsurance program unless prompt and immediate action is taken by the Department to monitor lender performance and to impose appropriate sanctions where necessary.

As you know, one of the primary objectives of the Coinsurance program was to facilitate the processing of multifamily mortgages by allowing private lenders to perform the underwriting, loan servicing, and management functions in return for sharing part of the insurance risks with HUD. The delegation of these underwriting responsibilities to lenders was intended to reduce the exposure of the FHA Insurance Fund, and provide staff savings to HUD. However, to provide adequate safeguards under the program and ensure that lenders engage in prudent underwriting practices, the coinsurance regulations mandated that HUD staff carefully monitor lender performance. As such, HUD Handbook 4566.1, Coinsurance for Mortgage Lenders, Section 223(f), incorporates a number of control mechanisms which include conducting on-site reviews, post-endorsement monitoring and periodic audits by the Commissioner.

To date, however, the Department has been quite reticent in monitoring lenders and taking appropriate sanctions where lender abuses have been found. Because of our concern about the quality of loans originated under the 223(f) program, MBA has been monitoring the default activity of 223(f) mortgages. Our review of the data indicates that approximately eight (8) projects totalling $122 million are in default — or five (5) percent of the total $2.425 billion HUD has underwritten in 223(f) coinsured mortgages. These figures are quite alarming in light of the brief two-year history of the 223(f) Coinsurance program.

MBA is deeply concerned that these projects could go into foreclosure resulting in a tremendous financial loss to the Department and posing a threat to the future of the Coinsurance program. Such a development would have a devastating effect on the mortgage banking industry, particularly for those lenders who have fully complied with HUD guidelines and invested a substantial portion of their company's capital and resources into the Coinsurance program.

Although MBA understands the financial constraints that have been imposed on the Department as a result of the Gramm-Rudman Budget Act, we strongly believe that the Department must allocate additional staff and resources to ensure that lender performance is adequately monitored. In addition, since MBA recognizes the difficulties associated with the implementation of enforcement actions on a program with a small number of participants, we recommend that HUD develop default thresholds which would limit the number of defaults a lender may have in its loan portfolio. This proposal would not only provide HUD with an automatic enforcement tool to regulate the coinsurance activity of specific lenders, but would also protect the Department from accepting new projects from lenders with high default percentages. We will be pleased to work with HUD concerning the development of thresholds and the appropriate sanctioning procedures, such as pre-closing review.

Mr. Secretary, in an effort to provide a financially healthy and administratively sound Multifamily Coinsurance program, MBA requests your immediate attention to these problems. We are appreciative of HUD's consideration of industry comments, and we look forward to further dialogue on these matters.

Very truly yours,

Ronald F. Poe

Ronald F. Poe

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Attachment A

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
THE SECRETARY
WASHINGTON, D.C. 20410

August 4, 1986

Mr. Ronald F. Poe
President
Mortgage Bankers Association
of America
1125 Fifteenth Street, NW
Washington, DC 20005

Dear Mr. Poe:

Thank you for your letter of July 8, 1986 about your concerns regarding the multifamily coinsurance programs administered by this Department.

I share your interest in the success of the coinsurance program and recognize that monitoring is a critical element in such a success. I have made additional commitments to this important Administration program objective. The FHA Commissioner's office has taken steps to increase the Housing organization's sensitivity and responsiveness to the coinsurance program. The number of staff having a full time involvement in coinsurance has been markedly increased. A new Coinsurance Division has been established which includes, as a separate entity, a Coinsurance Monitoring Branch. This Branch will specifically focus on the program's activity to insure that it is progressing in the best manner possible with top quality underwriting and servicing of coinsured loans. In this same regard, I have instructed the Office of Housing to hire five additional professional staff specialists to assist in this area of monitoring. Administrative resources, including travel funds, will continue to be made available to enable HUD staff to travel to coinsurance sites. These activities will enhance our monitoring efforts and continue to allow this important Administration priority to grow. This improved monitoring ability will aid us in giving the needed direction to lenders so that potential losses to the insurance fund can be avoided and/or reduced.

We have also moved forward in the area of data monitoring of the coinsurance activity through the use of new micro-computers and associated software. The software is especially designed to give our limited staff the tools to determine whether or not coinsurance underwriting is performed in the manner that we expect. In addition, this software will give us the ability to maintain timely reports and an overall data resource system for the active coinsurers.

Since the program became operational, we have actively monitored lender and field office submissions, endorsement packages, computer data input and other similar material to identify problem areas and programmatic improvements that could be made. We are continuing to actively monitor the coinsurers through large scale detailed on-site reviews. We have, in the past, through these reviews, taken steps to sanction coinsurers who we found to be performing in manners that were not envisioned by the program. In two instances, approved lenders were required to submit underwriting processing to HUD before issuing commitments until appropriate improvements were made. We fully intend to maintain this vigilance and will take whatever steps are necessary to keep the high quality of performance that will insure its continued success.

Also, your recommendation and offer of assistance regarding default thresholds will be considered. Your concerns and comments are helpful, timely and very much appreciated. We will continue to develop our capabilities and take the steps necessary to ensure an efficient and effective coinsurance program.

Very sincerely yours,

Samuel R. Pierce, Jr.

Attachment B

Coinsurance program features—responsibilities, fees and other requirements

Division of responsibilities

The coinsuring lender performs all processing, underwriting, closing, loan servicing, management oversight and disposition functions. The requirements and procedures relating to these functions are basically the same as under the Department's full insurance programs.

HUD Field Offices continue to perform certain non-delegated review responsibilities, such as environmental clearance, previous participation review, and compliance with Davis-Bacon requirements. HUD has established specific timeframes for performing each of these functions to ensure that coinsuring lenders receive prompt responses.

In addition to the above involvements, HUD Field Offices conduct an independent market review of 221(d) and 232 new construction/substantial rehabilitation cases, and certain 223(f) and 232 existing project cases where vacancy and/or rent increase percentages exceed established thresholds. These market reviews are required to assure that coinsurance does not disrupt the housing or mortgage market, or adversely impact other Federally-insured projects in the same market area.

Capital requirements

For the 221(d) and 223(f) programs, the lender must have sound capital resources (SCR) of at least $1,500,000, including at least $500,000 in liquid funds, which may be in the form of an unconditional and irrevocable letter of credit acceptable to HUD. The lender must maintain additional SCR of at least $1 for every $300 of outstanding principal indebtedness on mortgages it has coinsured under these sections.

For the 232 program, the lender must have initial SCR of at least $1,500,000, all of which must be in liquid funds. Up to $500,000 of this amount may be in the form of an unconditional and irrevocable letter of credit acceptable to HUD. The lender must also establish and maintain a dedicated account, funded initially with at least $500,000 of liquid funds. Funds in this account are credited toward the lender's SCR requirement. The lender must deposit and maintain the following additional funds in the dedicated account:

- A portion of its application and processing fees, in accordance with the following schedule:
  - $1 for every $150 of outstanding principal indebtedness on mortgages it has coinsured under Section 232, until the reserve reaches $3,000,000; and
  - $1 per $300 thereafter.
- An amount equal to four years of the lender's share of the annual MIP for each project, to be deposited at the time of each loan closing or in increments within four years following closing.

Source: "Financing and Investing in Multifamily Housing with HUD's Multifamily Coinsurance Programs", U.S. Department of Housing and Urban Development, Draft Brochure, 1989

Attachment C

1125 Fifteenth Street, N.W.
Washington, D.C. 20005

Mortgage Bankers Association of America

Catherine I. Pharis
Chairwoman
Insured Project Committee
(202) 775-9555

March 26, 1990

TO: Ann Hadley vom Eigen

FROM: Catherine I. Pharis CIP

RE: Treatment of Coinsurance Portfolios by HUD

As you are aware, we have been working with HUD on the issue of the treatment of existing coinsurance portfolios, given the precipitous actions by the Department to terminate the coinsurance programs. HUD appears to have agreed in concept to the need for HUD to provide an ability for coinsuring lenders to convert their existing portfolios from coinsurance to full insurance in order to alleviate the financial problems of coinsuring lenders that have been created in large part by the Department's decision to terminate the program.

Given the critical nature of the issue, we formed an Ad Hoc Task Force, which is being chaired by the Chairman of the Coinsurance Subcommittee. The membership of the Task Force includes seven members, representing a broad range of coinsuring lenders, with approximately $3.5 Billion in coinsured loans in their portfolios.

We requested and were granted a meeting with HUD staff on Thursday, March 15 to discuss this issue. All members of the Ad Hoc Task Force were in attendance at that meeting, as were several members of MBA's staff. GNMA representatives were also present.

We opened the meeting by commending the Department for its recognition of the need to provide a conversion possibility for lenders. We further acknowledged the economic hardship that has been placed on coinsuring lenders by the Department's decision to terminate the coinsurance programs.

A proposal was put forth by the Ad Hoc Task Force, as follows:

a) Coinsuring lenders would be able to convert all loans (including those currently in default) to coinsurance under the proposal;

Attachment C

b) Upon conversion to full insurance, HUD would receive 100% of the 50 basis point MIP in exchange for taking 100% of the risk;

c) The coinsuring lender would pay over to HUD the $1/300 of mortgages converted, less the amount of GNMA's capital requirements for that portfolio (0.20%), or a total of 0.13%;

d) No payment would be required for conversion of the following loans:

   (i) Loans closed by "Limbo Lenders" under precommitment reviews imposed under Coinsuring Lender Letter 89-4. "Limbo Lenders" are those who, at HUD's invitation, applied for and received preliminary approval to act as coinsuring lenders, but never were given approval to independently issue commitments. These lenders closed loans on a precommitment review basis, meaning that HUD completed a thorough review of all facets of underwriting, and approved the underwriting and loan amounts prior to issuance of any commitment by the lender. This would include all coinsured loans closed under the Section 232 program;

   (ii) Loans currently being processing and closed in accordance with Coinsuring Lender Letters 90-1 and 90-2, which impose precommitment reviews on all loans processed by all lenders commencing with the issuance date of 90-1. Again, HUD reviewed these loans and approved the underwriting and loan amounts prior to issuance of commitments by the lenders.

   Conversion of these loans would require only that the lender agree that, in the future, the entire 0.50% MIP go to HUD.

e) For Section 232 participants, the Dedicated Capital Account would be released immediately upon conversion of the portfolio to full insurance;

f) Conversion of portfolios from coinsurance to full insurance must be at the option of the Lender. Lenders could not convert loans on a deal-by-deal basis, but would have to elect to convert 100% of their portfolios.

The Task Force pointed out to HUD that a reasonable conversion program would assist the Department in minimizing potential losses under the coinsurance programs by avoiding future dumping of portfolios on GNMA in the event that lenders were no longer able to carry even one default in their portfolios due to their inability to generate new business due to the termination of the programs.

Attachment C

We discussed with HUD possible ways to have the lenders stay involved with workouts and foreclosures on their coinsurance portfolios even after conversion to full insurance. Given the present staffing levels at HUD, and the level of involvement of coinsuring lenders in these properties to date, lenders could provide a valuable asset to the Department by assisting in this way.

Conversion to full insurance would also give lenders resources that are not available under coinsurance to facilitate workouts, including, but not limited to, access to operating loss loans under the Section 241 program and an ability to sell projects with mortgage insurance in place. As many of you are aware, the lack of availability of financing for multifamily housing projects caused by the S&L crisis, FIRREA, the termination of the coinsurance program, Freddie Mac's changes in underwriting guidelines, etc. have made it increasingly difficult for lenders to sell projects at their current values. An ability to provide mortgage insurance on these loans would go a long way to minimize losses incurred under the program.

We will continue to work with HUD to come to a mutually acceptable program for portfolio conversion, and will keep you advised as to our progress.

STATEMENT OF LARRY DALE
SENIOR VICE PRESIDENT
FOR MULTIFAMILY FINANCE AND HOUSING INITIATIVES
FANNIE MAE
BEFORE THE HUD/MOD REHAB INVESTIGATIVE SUBCOMMITTEE
OF THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
MARCH 27, 1990

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE: I AM LARRY DALE, SENIOR VICE PRESIDENT FOR MULTIFAMILY FINANCE AND HOUSING INITIATIVES AT FANNIE MAE.

BY WAY OF BACKGROUND, FANNIE MAE HAS BEEN VERY ACTIVE IN MULTIFAMILY HOUSING, ESPECIALLY DURING SEVERAL IMPORTANT PERIODS.

- WE WERE A PARTNER WITH FHA AND GNMA IN FINANCING SEVERAL KEY LOW INCOME HOUSING PROGRAMS, INCLUDING THE SECTION 236 AND TANDEM PROGRAMS. WE OWN, AT THIS TIME, APPROXIMATELY FOUR AND A HALF BILLION DOLLARS IN SUCH MORTGAGES.

- WE WERE ALSO ACTIVE FROM 1984 THROUGH 1986 DURING THE GREAT BOOM IN PRODUCTION, PARTICULARLY IN SUPPORTING HOUSING FINANCE AGENCY TAX EXEMPT FINANCING. WE FINANCED OVER $2 BILLION IN THIS PERIOD.

MORE RECENTLY, BEGINNING IN MID 1987, AND COINCIDENTAL WITH MY ARRIVAL AT FANNIE MAE, CHAIRMAN DAVID MAXWELL GAVE NEW DIRECTIONS

TO OUR INVOLVEMENT IN MULTIFAMILY HOUSING. IN JUNE 30, 1987, WE OWNED OR GUARANTEED A TOTAL OF $8.8 BILLION IN MULTIFAMILY HOUSING PRODUCT, CONSISTING OF $3.9 BILLION IN CONVENTIONAL LOANS AND $4.9 BILLION IN FHA INSURED MULTIFAMILY LOANS. BY DECEMBER 1989, WE OWNED OR GUARANTEED $16.5 BILLION IN MULTIFAMILY LOANS, WITH $4.5 BILLION IN FHA INSURED LOANS AND $12 BILLION IN CONVENTIONAL LOANS. THIS REFLECTS A THREE-FOLD INCREASE IN TWO YEARS IN CONVENTIONAL MULTIFAMILY LOAN ASSETS UNDER MANAGEMENT.

LAST YEAR, WE BOUGHT OR GUARANTEED APPROXIMATELY $5 BILLION IN MULTIFAMILY MORTGAGES.

FANNIE MAE'S BASIC MULTIFAMILY PROGRAMS ARE SPLIT BETWEEN MORTGAGE-BACKED SECURITIES TRANSACTIONS AND PORTFOLIO PURCHASES WHICH WE CALL CASH TRANSACTIONS. LAST YEAR, WE DID APPROXIMATELY $3.2 BILLION IN MBS FINANCING AND $1.8 IN CASH.

LET ME EXPLAIN BOTH PROGRAMS. THE PORTFOLIO ACQUISITION (CASH) PROGRAM, INCLUDES DELEGATED UNDERWRITING AND SERVICING (DUS), PRIOR APPROVAL, AND NEGOTIATED CASH PURCHASES OF SHELF PRODUCT.

PRIOR APPROVAL AND DUS SHARE COMMON UNDERWRITING STANDARDS; HOWEVER, IN DUS WE HAVE SPECIALLY APPROVED 25 LENDERS IN A RISK-SHARING ARRANGEMENT WHICH ALLOWS THEM TO UNDERWRITE AND SELL

LOANS TO FANNIE MAE WITHOUT OUR PRIOR APPROVAL. IN PRIOR APPROVAL, FANNIE MAE STAFF IN OUR REGIONAL OFFICES UNDERWRITE EACH LOAN.

SINCE THE DUS PRODUCT WAS INITIATED IN 1988, WE HAVE COMMITTED TO PURCHASE APPROXIMATELY $2 BILLION IN MULTIFAMILY MORTGAGES FROM APPROVED DUS LENDERS. OF COURSE, THESE LENDERS MUST STAY WITHIN THE UNDERWRITING PARAMETERS WE ESTABLISHED FOR THE PROGRAM. I MAY ADD HERE THAT OUR POST-PURCHASE REVIEW PROCESS TO ASSURE COMPLIANCE IS A RIGOROUS REVIEW. I AM SURE OUR DUS LENDERS WOULD AGREE. IN RETURN FOR THIS DELEGATION OF AUTHORITY, THE LENDERS AGREE TO SHARE THE RISK OF LOSS WITH US. IN A NORMAL TRANSACTION, THE LENDER IS LIABLE FOR THE FIRST FIVE PERCENT OF THE LOAN, 25% OF THE NEXT 20%, AND 10% OF ANY REMAINING LOSS. THE PRODUCT IS A MANDATORY DELIVERY FIXED RATE LOAN WITH A 7- 10- or 15-YEAR BALLOON AND A 35-YEAR AMORTIZATION SCHEDULE. IT IS FOR $1-50 MILLION APARTMENT LOANS ON EXISTING FACILITIES ALTHOUGH THESE FACILITIES MAY HAVE BEEN RECENTLY COMPLETED OR THEY MAY NEED MODERATE REHABILITATION. THE BASE LOAN AMOUNT WOULD BE NO MORE THAN THE LESSER OF 80% OF LOAN-TO-VALUE, OR THE AMOUNT SUPPORTED BY AT LEAST 115% DEBT-SERVICE COVERAGE. HIGHER LOANS ARE PERMITTED ONLY IF ADDITIONAL, HIGH QUALITY COLLATERAL IS PROVIDED TO FANNIE MAE.

TODAY YIELDS TO FANNIE MAE ARE SLIGHTLY OVER 9 5/8 FOR 7- AND 10-YEAR LOANS, AND ABOUT 9 7/8 FOR 15-YEAR LOANS. THIS REPRESENTS AN INCREASE OF ABOUT A HALF PERCENT OVER THE YIELD LEVELS OF A COUPLE OF MONTHS AGO.

IN PRIOR APPROVAL, WE USE THE SAME UNDERWRITING STANDARDS. HOWEVER, OUR CAPACITY FOR VOLUME IS LIMITED BY THE STAFF INTENSIVE, RETAIL NATURE OF THE BUSINESS. OUR STAFF IS ALSO BUSY WITH OUR DUS MONITORING AND WITH OUR LOW- AND MODERATE-INCOME INITIATIVES UPON WHICH WE HAVE SEPARATELY TESTIFIED BEFORE CONGRESS. THUS, WE GENERALLY DO BOUTIQUE TRANSACTIONS IN PRIOR APPROVAL; THOSE BEING SMALLER OR LARGER LOANS, LOANS OUTSIDE OF NORMAL STANDARDS, OR LOANS FROM SMALLER COMMUNITIES OR LENDERS.

OUR MULTIFAMILY MORTGAGE-BACKED SECURITIES (MBS) PRODUCT LINE IS SIMILAR TO OUR SINGLE-FAMILY MBS PROGRAM. WE SECURITIZE POOLS OF MORTGAGES THROUGH THE MBS STRUCTURE AND THE RESULTING SECURITIES CAN BE SOLD TO INVESTORS OR HELD BY THE LENDER. DURING THE PAST TWO YEARS, LENDERS HAVE SWAPPED MORE THAN $7 BILLION IN MULTIFAMILY LOANS FOR MULTIFAMILY MBS. LOANS SECURED BY RENTAL APARTMENTS AND COOPERATIVE BLANKET LOANS ARE ELIGIBLE. SWAP CONTRACTS, COVERING ONE OR MORE POOLS, GENERALLY START AT $50 MILLION AND HAVE RANGED UPWARD TO MORE THAN $500 MILLION. MBS MAY BE BACKED BY ADJUSTABLE OR FIXED RATE MORTGAGES. WE ACCEPT ARMs WITH A VARIETY OF INDICES AND OTHER LOAN FEATURES.

MBS BACKED BY FIXED RATE LOANS MAY BE REPACKAGED AS REMICs. REMIC SHORT, INTERMEDIATE AND LONG-TERM TRANCHES CAN BE MATCHED TO THE NEED OF DIFFERENT CLASSES OF INVESTORS AND MAY RESULT IN A BETTER PRICE FOR THE LENDER.

IN EVALUATING A PORTFOLIO FOR THIS PROGRAM, WE LOOK AT PROJECT LOCATION AND UNDERWRITING CRITERIA TO COMPLETE OUR REAL ESTATE DUE DILIGENCE; A SAMPLE OF EACH TYPE OF NOTE AND MORTGAGE TO DETERMINE POOLING ISSUES; AND FINANCIAL STATEMENTS TO ASCERTAIN CREDIT WORTHINESS. WE NEGOTIATE AN UP-FRONT FEE, A PERIODIC GUARANTY FEE AND CREDIT ENHANCEMENTS. FANNIE MAE STATUTORY LOAN LIMITS APPLY.

ONE ADDITIONAL ADVANTAGE OF THE MBS STRUCTURE IS THAT WE CAN USE THE MBS FOR BOTH SINGLE PROJECT CREDIT ENHANCEMENTS AND FOR TAX EXEMPT MORTGAGE POOLS. FOR EXAMPLE, WE RECENTLY CLOSED A $50 MILLION DEAL WITH THE MASSACHUSETTS HOUSING FINANCE AGENCY FOR LOW INCOME HOUSING.

INCREASINGLY, WE ARE DOING A NUMBER OF LOW INCOME TAX-EXEMPT FINANCINGS WITH OUR DUS AND PRIOR APPROVAL PROGRAMS. MORE AND MORE, WE ARE ABLE TO WORK WITH AFFORDABLE HOUSING PRODUCTS OF ALL TYPES.

IT IS IMPORTANT TO NOTE HERE THAT THE EFFICIENT FINANCING SYSTEM AT FANNIE MAE RESULTS IN MULTIFAMILY MORTGAGE RATES WHICH ARE

COMPETITIVE OR EVEN SLIGHTLY BELOW THOSE OFFERED IN SINGLE-FAMILY HOUSING. THIS IS TRUE SINCE WE HAVE A YIELD MAINTENANCE AGREEMENT WITH OUR BORROWERS SO THAT THE RISK OF PREPAYMENTS IS REDUCED FROM THAT OF A SINGLE-FAMILY MORTGAGE POOL.

I WOULD ALSO SUGGEST TO YOU THAT MULTIFAMILY HOUSING IS INCREASINGLY, AFFORDABLE HOUSING. THE AVERAGE INCOME OF RENTER HOUSEHOLDS HAS FALLEN TO APPROXIMATELY ONE HALF THAT OF HOME OWNERS. WE HAVE REVIEWED THE RENT STRUCTURES IN THE DUS LOANS WE HAVE ACQUIRED OVER THE PAST YEAR. ON AVERAGE, THE RENTS ARE AFFORDABLE BY THOSE WHO EARN 80% OR LESS OF MEDIAN INCOME. WE DO NOT CLAIM THIS TO BE A SCIENTIFIC STUDY, BUT, ALONG WITH OUR SISTER AGENCY, FREDDIE MAC; WE HAVE FOUND THAT OUR MULTIFAMILY LOAN PORTFOLIOS ARE INDEED HOUSING FAMILIES OF MODEST MEANS.

FANNIE MAE BELIEVES THAT THERE IS AN IMPORTANT ROLE FOR THE SECONDARY MARKET TO PLAY IN APARTMENT FINANCING. BY PROVIDING PRUDENT UNDERWRITING STANDARDS AND COMMON CREDIT QUALITY TO MULTIFAMILY LOANS, THE SECONDARY MARKET CAN EXPAND CAPITAL AVAILABILITY AND LIQUIDITY ON A NATION-WIDE BASIS WHILE CONTRIBUTING TO BETTER LOAN PERFORMANCE AND LOWER INTEREST RATES. AS YOU CAN SEE, THE ROLE IS NOT DISSIMILAR TO THE ROLE WE PLAY IN OUR SINGLE-FAMILY LENDING PROGRAMS. HOWEVER, BECAUSE EACH APARTMENT PROPERTY IS REALLY A MEDIUM SIZED INVESTMENT, AND BECAUSE EACH LOAN IS GENERALLY LARGE (AT LEAST BY SINGLE-FAMILY

LENDING STANDARDS); FANNIE MAE HAS FOUND IT NECESSARY TO ESTABLISH PATTERNS OF BUSINESS THAT ARE SOMEWHAT DIFFERENT FROM THOSE OF SINGLE-FAMILY LENDING.

THE WAY WE DO A LARGE VOLUME OF BUSINESS IS TO RELY ON FULL OR PARTIAL RECOURSE FROM OUR LENDERS. THIS RISK-SHARING FEATURE CHARACTERIZES BOTH OUR DUS AND MBS PRODUCT LINES. OUR LENDERS ARE THE FRONT-LINE TROOPS. THEY UNDERSTAND THEIR LOCAL MARKETS AND THE RENTAL REAL ESTATE. FANNIE MAE, AS A SECONDARY MARKET AGENCY, IS SOMEWHAT REMOVED FROM LOCAL REAL ESTATE MARKETS. WHILE WE CAN FULLY UNDERWRITE A PROJECT LOAN AS EFFECTIVELY AS A PRIMARY LENDER, IT TAKES US SIGNIFICANT TIME AND EFFORT TO DO SO. WE ARE MUCH MORE EFFECTIVE IN A TRUE SECONDARY MARKET POSITION SHARING RISK WITH THE PRIMARY MARKET LENDER.

IN ORDER TO UNDERTAKE A VOLUME, NATIONWIDE LOAN PROGRAM WHILE ASSURING PROPER CREDIT QUALITY, WE HAVE FOUND IT PRUDENT TO ENTER INTO RISK PROTECTION OR RISK SHARING AGREEMENTS WITH MOST OF OUR PRIMARY MARKET LENDERS. THE AGREEMENTS ARE IN ADDITION TO OUR UNDERWRITING STANDARDS, OUR DUE DILIGENCE, AND OUR POST PURCHASE REVIEW AND MONITORING PROCESS. SINCE OUR MULTIFAMILY LENDING PROGRAMS WERE REVISED IN 1987/88 TO INCORPORATE THESE FEATURES, OUR LOAN PROGRAMS HAVE BEEN VERY ACTIVE AND OUR DELINQUENCY EXPERIENCE HAS BEEN EXCELLENT.

UNFORTUNATELY, THE APARTMENT FINANCE BUSINESS IS NOW ENCOUNTERING A CAPITAL SQUEEZE WHICH HAS AFFECTED SOME OF FANNIE MAE'S MULTIFAMILY LENDING PRODUCTS. WITH THE ADVENT OF NECESSARY RISK-BASED CAPITAL STANDARDS FOR REGULATED THRIFTS AND BANKS, FULL OR PARTIAL RECOURSE AGREEMENTS HAVE BEEN DIFFICULT FOR MANY PRIMARY MARKET LENDERS.

FANNIE MAE'S COMMENTS ON THE THRIFT RISK BASED CAPITAL REGULATIONS STRESS THE NEED FOR SOME ACCOMMODATIONS FOR APARTMENT LOANS AS FOLLOWS:

> "**Risk Weight of Quality Residential Multifamily Loans Should be 50%.**
>
> The Proposal classifies all multifamily loans at 100 percent and makes them all twice as "expensive" as the highest quality single-family lending in terms of capitalization.
>
> By contrast, the Proposal recognizes that certain single-family mortgages bear characteristics that substantially reduce the risk of loss for those assets, in comparison to other single-family home loans. Those distinctions form the basis for creating two risk weights for these loans, with the most creditworthy placed in the 50 percent risk basket.
>
> Fannie Mae believes that just as there are very high quality single-family loans with markedly lower risk, there are also multifamily loans that are equally creditworthy and that should receive equally favorable risk weighting.
>
> Fannie Mae's experience has been that thrifts have been the major lenders for smaller apartment loans for 20 units or less. And 55% of all apartment units in the United States are in such small developments. Such financing is uniquely suited to the underwriting expertise of local lenders in the community. But the 100 percent risk weighting, in our view, will make this type of lending too expensive for the most experienced thrifts making multifamily loans with extremely low default risk. Thrifts' exit from this financing activity

would particularly prejudice low-, and moderate-, and middle-income families, as renters on the average have a family income that is only about half that of homeowners.

This aspect of the Proposal fails to strike the proper balance between capital adequate to buffer losses but not so high as to adversely affect thrifts' ability to compete for capital.

The proposed weighting of all multifamily loans at 100 percent risk weight would place them in the same category with assets such as general commercial loans, purchased and excess servicing rights, consumer loans, and land and nonresidential construction loans. This risk weight, which is double the weight assigned to 1-4 family loans that meet certain performance and down payment criteria, applies regardless of varying risk factors such as a fixed or adjustable rate, and loan-to-value ratios.

The Board should avoid a result that so clearly conflicts with the housing mission explicit in many aspects of the Home Owners' Loan Act, including the recent amendments in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). Providing risk categories of 50% and 100% would reflect more accurately the varying credit risk of multifamily loans while addressing congressional support for thrifts' housing mission. We believe a two step screening process could be devised to identify lower risk multifamily loans.

In the first step, examiners would determine whether an institution has a satisfactory record of originating, underwriting and servicing such loans (or absent such a record, has qualified staff and management to predict satisfactory performance for such lending).

If the institution passes this subjective evaluation, a 50 percent weight could be assigned to all the multifamily loans that met either of the two descriptions below:

A. Fixed rate loans with
    (1) a balloon of no less than 7 years;
    (2) a loan-to-value ratio not greater than 80 percent;
    (3) a debt service coverage ratio of 1.2 or greater; and,
    (4) at least one year of seasoning with a satisfactory payment history.

or

B. Loans with less than a year's seasoning and ARM multifamily loans could qualify for lower risk treatment if bearing loan-to-value ratios of less than 70%, and a good payment history for the time since origination.

In addition to this specific recommendation, we would suggest that multifamily senior/subordinate capital requirements parallel those of single-family and that risk-sharing agreements between regulated primary market lenders and the secondary market be recognized in your risk based capital standards."

FANNIE MAE WAS PLEASED THAT THE FINAL RISK BASED CAPITAL REGULATIONS RESPONDED IN A SIGNIFICANT WAY TO CONCERNS OF APARTMENT LENDERS WITH RESPECT TO APARTMENT FINANCING FOR PROJECTS OF 36 UNITS OR LESS.

HOWEVER, ALL MULTIFAMILY LENDING FOR PROJECTS OF OVER 36 UNITS IS STILL CONSIDERED TO BE IN THE 100% CAPITAL BASKET. THIS DIFFERS FROM SINGLE-FAMILY HOUSING WHERE A 50% RISK WEIGHT HAS BEEN ESTABLISHED FOR A LESS RISKY LOAN (I.E., A LOAN-TO-VALUE RATIO OF 80% OR LESS). WHAT THIS MEANS IS THAT LENDERS MUST HAVE MORE CAPITAL TO PARTICIPATE IN THE MULTIFAMILY HOUSING FINANCE BUSINESS. THERE IS ALSO NO ENCOURAGEMENT TO PUT THEIR MONEY IN SAFER LOANS IF THEY DO CHOOSE TO CONTINUE LENDING. THE REGULATIONS ARE PARTICULARLY STRINGENT IN THEIR TREATMENT OF RISK SHARING AGREEMENTS. EVEN THOUGH MUCH OF THE RISK IS NO LONGER THE PRIMARY LENDER'S, THE SAME AMOUNT OF CAPITAL IS REQUIRED AS FOR A LOAN THAT HAS NOT BEEN SOLD. THUS THE CURRENT RISK BASED CAPITAL REGULATIONS POSE SEVERAL DIFFICULT ISSUES FOR REGULATED APARTMENT LENDERS AND HAVE RESULTED IN A SLOW DOWN (OR CESSATION) OF MANY

APARTMENT LENDING PROGRAMS. I BELIEVE THAT THE REGULATORS ARE AWARE OF THESE ISSUES AND WE ARE HOPEFUL THAT THE DIALOGUE WITH THE APARTMENT LENDING INDUSTRY WILL CONTINUE IN SEARCH OF AN EQUITABLE SOLUTION.

WE AT FANNIE MAE BELIEVE THAT, PRUDENTLY UNDERTAKEN, MULTIFAMILY HOUSING FINANCE CAN REPRESENT A REASONABLE RISK TO LENDERS WHILE MAKING A TREMENDOUS CONTRIBUTION TO AFFORDABLE RENTAL HOUSING FOR AMERICA'S LOW-, MODERATE- AND MIDDLE-INCOME RENTER FAMILIES.

YOUR FEBRUARY 22 LETTER ASKED ME TO ADDRESS SEVERAL QUESTIONS IN MY TESTIMONY, THE ANSWERS TO THESE QUESTIONS FOLLOW FOR THE RECORD.

1. What aspects of FHA's multifamily mortgage co-insurance programs did you consider undesirable or otherwise flawed, when you embarked upon the development of FNMA's Multifamily Delegated Underwriting and Servicing Program ("DUS Program")?

> FANNIE MAE DID NOT DEVELOP DUS AS A COUNTERPOINT TO CO-INSURANCE. FANNIE MAE'S DUS PRODUCT VARIES FROM CO-INSURANCE IN MANY WAYS INCLUDING UNDERWRITING, LENDER RELATIONSHIPS, MONITORING, AND FEE STRUCTURE. OUR UNDERWRITING RELIES UPON ACTUAL RENTS AND EXPENSES; OUR LENDER RELATIONSHIPS ARE VERY RIGOROUS ON THE LENDER; OUR MONITORING IS VERY THOROUGH; AND OUR FEE STRUCTURE REWARDS QUALITY LOAN PERFORMANCE, NOT HIGH PRODUCTION VOLUMES.

2. By what means did FNMA determine that the terms and conditions of its DUS Program were both likely to protect FNMA against adverse risk of loss and to attract meaningful participation by competent, multifamily mortgage lenders?

FANNIE MAE USED ITS BEST JUDGEMENT, IN CONSULTATION WITH OTHER PROFESSIONALS, IN DEVELOPING PRUDENT WORKABLE STANDARDS FOR THE DUS PRODUCT.

3. What reasons explain that only a few participants in the DUS Program are insured depository institutions?

MANY PARTICIPANTS IN DUS (OVER HALF) ARE INSURED DEPOSITORY INSTITUTIONS. MY EARLIER COMMENTS ADDRESS CERTAIN DIFFICULTIES THEY ARE FACING IN OPERATING THE DUS PRODUCT UNDER THE NEW RISK BASED CAPITAL STANDARDS.

4. What FNMA staff resources are required to manage and implement the DUS Program? What other institutional capacities, including legal and financial, does FNMA possess that you consider essential to the success of the DUS Program?

FANNIE MAE HAS COMMITTED SUFFICIENT RESOURCES TO IMPLEMENT THE DUS PRODUCT IN MULTIFAMILY FINANCE AS WELL AS IN EACH OF OUR FIVE REGIONAL OFFICES AND IN FINANCE, LEGAL, AND OTHER AREAS OF THE CORPORATION. IT IS IMPOSSIBLE TO SPECIFY THE PRECISE NUMBER OF EMPLOYEES DEDICATED TO THE DUS PRODUCT IN THAT OUR MULTIFAMILY, LEGAL, AND FINANCE STAFF WORK ON MANY PRODUCTS CONCURRENTLY.

5. What is FNMA's experience in exercising its remedies or sanctions against participants in the DUS Program? Does this experience conform with FNMA's expectations at the time of its initiation of the Program?

WE HAVE LEVIED SANCTIONS IN A NUMBER OF INSTANCES WITH EXCELLENT RESULTS WHICH MEASURE UP TO OUR EXPECTATIONS. THE RESULTS ARE MEASURED IN TERMS OF IMPROVED LENDER PERFORMANCE.

6. What is FNMA's experience in having to modify the terms and conditions of the DUS Program in response to Program experience and changes in economic circumstances?

DUS HAS BEEN CLARIFIED AND MODIFIED FROM TIME TO TIME BY LENDER MEMORANDUM AND GUIDE UPDATE. THESE MODIFICATIONS HAVE NOT POSED ANY EXTRAORDINARY PROBLEMS. MANY MODIFICATIONS HAVE BEEN MADE IN RESPONSE TO LENDERS' REQUESTS. OTHERS HAVE BEEN PURELY INFORMATIONAL. SOME HAVE BEEN INITIATED BY FANNIE MAE TO CLARIFY MATTERS OR ADDRESS PRODUCT ENHANCEMENTS OR DEFICIENCIES.

7. How does the termination of the FHA co-insurance programs affect FNMA with respect to the DUS Program participants, who are also participants in the co-insurance programs?

IN THE INSTANCES WHERE A DUS PARTICIPANT WAS ALSO A PARTICIPANT IN CO-INSURANCE, THE TERMINATION OF CO-INSURANCE HAD AN OBVIOUS EFFECT ON THE DUS PARTICIPANT'S BUSINESS PLANS WHICH WE ARE MONITORING. WHERE THE EFFECT HAS BEEN SERIOUS WE HAVE CURTAILED ACTIVITY WITH THE AFFECTED LENDER. IN OTHER INSTANCES, WE HAVE CONTINUED TO MONITOR THE LENDER'S PERFORMANCE, RESOURCES, AND FINANCIAL BASE.

8. In what manner might FNMA assist HUD in the management of the FHA co-insurance programs and the implementation of a full insurance, delegated underwriting program?

FANNIE MAE MAINTAINS A GOOD WORKING RELATIONSHIP WITH HUD/FHA ON A NUMBER OF MATTERS OF MUTUAL INTEREST INCLUDING MULTIFAMILY FINANCE. WE EXPECT THIS TO CONTINUE AND STAND READY TO SUPPORT HUD/FHA EFFORTS AND PROGRAMS IN ANY WAY WE CAN.

MR. CHAIRMAN AND COMMITTEE MEMBERS, FANNIE MAE STANDS READY TO HELP YOU THINK THROUGH AND ASSIST THE INDUSTRY IN CONTINUING TO HAVE A HEALTHY MULTIFAMILY LENDING ENVIRONMENT. I WILL BE PLEASED TO DISCUSS CURRENT ISSUES AND TO ANSWER OTHER QUESTIONS AS YOU PLEASE. THANK YOU.

STATEMENT OF

WARREN LASKO

EXECUTIVE VICE PRESIDENT
MORTGAGE BANKERS ASSOCIATION OF AMERICA

before the

HUD/MOD REHAB INVESTIGATION SUBCOMMITTEE

of the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

ROUND-TABLE HEARING DISCUSSION
HUD'S MULTIFAMILY CO-INSURANCE PROGRAMS

March 27, 1990

Mr. Chairman and Members of the Subcommittee, my name is Warren Lasko, and I am Executive Vice President of Mortgage Bankers Association of America. I have been asked to testify today not in that capacity, but because I was employed at the Government National Mortgage Association (GNMA) during the development of the Federal Housing Administration (FHA) co-insurance program.

I will try to address the questions you raised, Mr. Chairman, in your February 22 letter asking me to testify at this hearing.

1. In what capacities did you serve at the Department of Housing and Urban Development (HUD) during the period, 1974 to 1983?

I worked for HUD in a number of capacities from 1968 until February 1985. From 1974 to 1976, I was Deputy Director of the Office of Policy Development in what then was called the Office of Housing Production and Mortgage Credit. From 1976 to 1977, I was Director of HUD's San Diego Insuring Office; from 1977 to 1982, I was Vice President for Mortgage Backed Securities at GNMA; and from 1982 to 1985, I was Executive Vice President of GNMA.

2. To the best of your recollection, at the time that GNMA was first asked to consider guaranteeing securities backed by co-insured multifamily mortgage loans what judgment did you and other involved GNMA staff make regarding the risk of default by co-insurers on their issuer obligations to GNMA? Did you perceive that co-insurers would have the capacity to satisfy the potential liquidity demands that co-insurers assumed as GNMA issuers?

To the best of my recollection, at the time that GNMA was first asked to consider guaranteeing securities backed by co-insured mortgages, I and others at GNMA had as our primary objective the goal of assuring that GNMA would have no risk of loss on the mortgages either if there was a default on the mortgage or if a co-insured lender defaulted on its obligations as a GNMA securities issuer. It was not GNMA's role to underwrite or assume risk of loss on the mortgages themselves. That was FHA's function.

3. To the best of your recollection what was the basis for GNMA's insistence that FHA provide GNMA with an indemnification against loss with respect to defaulted co-insured loans as a condition to GNMA's undertaking to guarantee securities backed by such loans?

The basis of GNMA's insistence that FHA fully insure the co-insured loans of any defaulted co-insurer was that it was not GNMA's role to be responsible for mortgage losses. If GNMA had to step into the shoes of a securities issuer, it wanted assurance there would be no risk to GNMA of losses on the mortgages.

GNMA is in the business of guaranteeing the performance of securities issuers in relation to the security holders. GNMA is not in the business of underwriting mortgages or guaranteeing the performance of mortgagors. GNMA does not have the statutory charter nor the capability of underwriting individual loans. Nor is it capable of determining whether the lender/issuer can adequately underwrite loans. GNMA also was not in a position to take over the co-insurer's responsibility for disposing of a property underlying a defaulted mortgage. On a fully insured loan, GNMA could assign the mortgage to FHA, which had those capacities, rather than take on the responsibility of property disposition and the allied roles of maintaining the property until a new owner could be found.

4. To the best of your recollection did HUD's Office of General Counsel provide GNMA with a legal opinion that the FHA indemnification of GNMA was legally valid and enforceable by GNMA?

It is my recollection that GNMA received a legal opinion from lawyers in HUD's Office of General Counsel that stated that the agreements reached between GNMA and the Office of Housing were legally valid and enforceable.

5. To the best of your recollection did GNMA impose any programmatic requirements--other than the FHA indemnification--with respect to co-insured lenders who became GNMA issuers that were different from the requirements that applied to fully insured lenders who became GNMA issuers? If your answer is affirmative, what were these requirements?

To the best of my recollection, the programmatic requirements for co-insured loans (and lenders) were the same as the requirements for fully-insured loans (and lenders).

6. Does the record of GNMA's performance indicate that it has enforced its remedies against defaulting co-insurers as vigorously and timely as it has enforced its remedies against defaulting issuers, who held fully insured loans?

Since I left GNMA before there were any defaults by co-insured lenders, I have no direct knowledge of GNMA's enforcement of its remedies against defaulting co-insured lenders.

7. In your view does GNMA's contractual arrangement with Coopers & Lybrand serve as a useful model for HUD in performing its FHA insurance functions?

Since I left GNMA before the contract with Coopers & Lybrand was initiated, I have no knowledge of whether it would serve as a useful model for HUD in performing its FHA insurance functions.

8. Do you believe that the availability of Coopers & Lybrand to GNMA has resulted in GNMA being more willing to enforce vigorously its remedies against defaulting GNMA issuers?

During the time I was at GNMA, there was no unwillingness on the part of GNMA to enforce vigorously its remedies against defaulting GNMA issuers. Since I left GNMA, I have no knowledge of the effect that the availability of Coopers & Lybrand has had on GNMA's response to defaults.

9. What in your view were the principal design flaws in the FHA multifamily mortgage co-insurance programs?

From GNMA's standpoint, there were no design flaws. GNMA protected its interests by assuring itself that, if a lender failed to live up to its obligations, and the mortgage was in default, GNMA would receive full insurance benefits. I understand that, since I left GNMA, situations have arisen in which HUD has been slow to pay GNMA these insurance benefits. To the extent this is the case, GNMA would bear an unanticipated cash flow drain until it recovers its losses through an insurance claim settlement from FHA.

Thank you, Mr. Chairman, for the opportunity to testify before this Subcommittee. I would be pleased to answer any questions you might have.

STATEMENT OF PETER MONROE

GENERAL DEPUTY ASSISTANT SECRETARY FOR HOUSING-
DEPUTY FEDERAL HOUSING COMMISSIONER-DESIGNATE
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
SEPTEMBER 28, 1989

Mr. Chairman, and members of the Committee. I appreciate the opportunity to appear before you to discuss certain aspects of HUD's multifamily coinsurance programs. I will attempt to give you an overview of coinsurance: what coinsurance provides; how coinsurance works; what coinsurance offers borrowers; and how coinsurance has been used in conjunction with the GNMA Mortgage-Backed Securities and the Section 8 Moderate Rehabilitation programs. I will also share with you HUD's perspective on what went wrong with coinsurance and the steps this Administration has taken to date to assert control of the program and limit HUD's losses.

It is timely for you to have this hearing today, as Secretary Kemp nears completion of a reform package which will make policy and program reforms affecting coinsurance. We look forward to working with this Committee as you deal with the Secretary's forthcoming proposals.

What Coinsurance Provides

Pursuant to the National Housing Act, FHA has had a long-standing commitment to provide mortgage insurance to encourage the production and preservation of affordable multifamily housing for low- and moderate-income families. Notwithstanding the problems that have beset coinsurance (which I will discuss later in some detail), coinsurance has in recent years become FHA's principle vehicle for meeting this commitment.

Coinsurance offers affordable multifamily housing without direct subsidies to tenants or developers by making available long-term, fixed-rate financing within statutory maximum per-unit mortgage limits. Average coinsured mortgages range from $26,000 per-unit for existing projects to $46,600 per-unit for new construction and substantial rehabilitation projects. This translates into average monthly rents (assuming utilities included) of $360 for existing projects and $600 for new construction substantial rehabilitation projects. Assuming tenants are paying 30% of income for housing, coinsurance makes existing housing available to families with incomes over $14,400/year and new/substantially-rehabilitated housing to families with incomes over $24,000/year. Both of these figures are well below the national median household income of $27,700. Coinsured loans finance roughly 50,000 existing units and 15,000 new and rehabilitated units each year.

History of Coinsurance

Coinsurance was authorized under the Housing and Urban Development Act of 1974, which added Section 244 to the National Housing Act. However, it was not until 1983 that coinsurance was implemented for HUD's multifamily programs. In May 1983, HUD implemented the Section 223(f) coinsurance program for the purchase or refinancing and limited repair of existing projects. In August 1984, HUD made this program more flexible by increasing the amounts that could be spent on repairs; allowing those repair costs to be included in the mortgage; and permitting completion of non-critical repairs after endorsement. In October 1984, HUD implemented the Section 221(d) coinsurance program for new construction and substantial rehabilitation of apartments and retirement service centers. In October 1988, HUD implemented the Section 232 coinsurance program for new construction and substantial rehabilitation of nursing homes, intermediate care facilities and board and care homes. This program also allows loans for acquisition or refinancing of existing, fully insured facilities.

To date, more than 100 lenders have applied to participate in one or more of the multifamily coinsurance programs. 35 lenders are currently fully approved to participate in one or more programs. 29 other lenders have received preliminary approval. Coinsuring lenders are now located throughout the country. Some operate on a national basis; others have chosen to focus their coinsurance activities in a particular region.

Since 1983, close to 1500 projects with a total mortgage value of approximately $9.5 billion have been coinsured. The following table provides a breakout of coinsured loans closed and coinsurance currently in force. The difference between the two sets of figures is attributable primarily to prepayments and/or refinancings of approximately $1 billion of Section 223(f) coinsured loans.

TABLE 1: PROGRAM VOLUME AS OF AUGUST 31, 1989

	Loans Closed		Coinsurance in Force	
	Projects	Mortgage Amount	Projects	Mortgage Amt.
Sec. 223(f)	1,223	$7,144,199,100	1,020	$6,026,103,100
Sec. 221(d)	236	2,296,102,000	236	2,296,033,600
Sec. 232	5	29,126,300	5	29,126,300
Total	1,464	$9,469,427,400	1,261	$8,351,263,000

How Coinsurance Works

Coinsurance is a joint venture between the private and public sectors in which lenders and HUD share mortgage insurance risk, thereby providing an alternative to traditional HUD full insurance financing for rental housing and residential healthcare facilities.

In full insurance, all loan processing and underwriting is done by HUD field offices and all risk is taken by the Federal Government. Under coinsurance, HUD delegates to selected private-sector mortgage lenders the authority to originate, process and underwrite mortgage loans and issue firm commitments that bind HUD to coinsure those loans. HUD also delegates to coinsuring lenders full responsibility for loan servicing and management oversight, as well as acquisition and disposition of defaulted projects. Under coinsurance, the coinsuring lender assumes a portion of the risk for each loan it makes. In return for the lender taking a share of the risk and greater processing, underwriting and servicing responsibilities, HUD allows the lender to collect various application, financing and placement fees (which HUD collects under the full insurance programs) and to share with HUD the initial and annual Mortgage Insurance Premiums.

In full insurance, when a default occurs, the lender may assign the mortgage to HUD and receive insurance benefits. (Actually full insurance covers 99% of the lender's loss, since HUD charges a 1% assignment fee.) HUD is then responsible for foreclosing the defaulted mortgage, managing the project once it is acquired and, ultimately, disposing of it.

In coinsurance, when a default occurs, the lender does not have the option of assigning the defaulted mortgage to HUD. Instead, the lender must foreclose the mortgage and can file a claim only after it has sold the project or twelve months have elapsed after the date the project was acquired. After deducting the sales proceeds (or the higher of two appraised values if the project was not sold), the lender must absorb a deductible equal to 5% of the outstanding mortgage balance. The remaining loss is shared 85% by HUD and 15% by the coinsuring lender.

What Coinsurance Offers Borrowers

Coinsurance offers borrowers the same basic benefits available under HUD's full-insurance programs. These include:

- Long-term, fixed-rate financing
- High loan-to-value ratio
- Low interest rates resulting from the credit enhancement offered by FHA coinsurance and the availability of funding through GNMA Mortgage-Backed Securities (Note: Over 98% of all coinsured loans have been funded through GNMA MBS.)
- Fully-assumable loans
- Non-recourse debt
- Limited restrictions on prepayment

In addition to providing the same basic benefits of full insurance, coinsurance offers borrowers a number of significant advantages.

- First, essentially "one-stop shopping." Borrowers deal with lenders they know and choose. Borrowers do not deal directly with HUD. HUD's involvements are limited and are handled by the lender.

- Second, borrowers deal with lenders who have greater flexibility to respond to their unique needs and those of their projects. For example, most coinsuring lenders offer a variety of financing packages, including funding through the issuance of GNMA Mortgage-Backed Securities and tax-exempt bond financing.

- Third, borrowers get fast-track processing and underwriting, fast delivery of firm commitments and reliable scheduling for loan closings and project development.

How Coinsurance Works with GNMA's Mortgage-Backed Securities Program

As I stated earlier in my testimony, virtually all multifamily coinsured loans have been funded through the issuance of GNMA Mortgage-Backed Securities (MBS). Just as a lender must apply to FHA to become an approved coinsuring lender, it must secure GNMA's approval to become an issuer/servicer of GNMA MBS.

Unlike fully insured loans which are readily tradable as whole loans in secondary markets, coinsured loans have virtually no liquidity, since they can only be sold to other coinsuring lenders and each sale or assignment of a coinsured loan must be approved by HUD. Generally, the purchaser (assignee) must assume the full coinsurance risk of the originating lender. Coinsuring lenders have resolved this liquidity problem by using the GNMA MBS program to securitize their coinsured loans. Each multifamily loan comprises a single "pool", and securities are issued in multiples of not less than $25,000. Approved GNMA issuers may issue both Construction Loan Certificates (CLCs) to fund construction loans and Project Loan Certificates (PLCs) to fund permanent project loans. GNMA securities are very salable to secondary market investors since timely payments of principal and interest are guaranteed by GNMA, which has the full faith and credit backing of the U.S. government.

Appended to my statement is a chart that illustrates how FHA's multifamily coinsurance and GNMA's MBS programs work together. This chart is numbered to show the sequence of events involved in the creation of a coinsured loan and the issuance of GNMA securities. The following is a summary of those events:

1. & 2. The lender purchases a guarantee commitment from GNMA and GNMA issues that commitment.

3. A "warehouse" bank provides the lender a "bridge" or "warehouse" loan.

4. The lender uses funds from the warehouse loan to make the mortgage loan, which FHA coinsures.

5. & 6. The lender issues GNMA securities to a securities dealer (broker), who, in turn, markets the securities to an investor.

7. & 8. The investor purchases the securities from the broker, who, in turn pays the lender.

9. The lender uses the proceeds from the sale of the securities to pay off the warehouse loan, thus completing the transaction.

For the duration of the pool, the lender is obligated to make timely monthly payments to the securities holder (investor). If the mortgagor defaults and the project is acquired and sold, the lender is also obligated to pass the sales proceeds to the investor and to pay off the remaining pool balance following HUD's payment of coinsurance benefits.

If the lender fails to make any of the required payments to investors, GNMA will make those payments. In the event of such default by a lender, GNMA has the right to take control of all the lender's loans that are in GNMA pools. The coinsurance regulations entitle GNMA to full indemnification by FHA for any losses GNMA sustains in the process of servicing and liquidating these pools.

How Coinsurance was Used in Conjunction with the Section 8 Moderate Rehabilitation Program (MRP)

As I stated earlier in my testimony, coinsurance does not provide direct subsidies to tenants, project owners or developers. Owners or developers have been permitted, however, to use HUD full insurance or coinsurance in conjunction with the Department's Section 8 programs.

The following points illustrate how the Mod Rehab program, the principal Section 8 program using coinsurance, worked:

- Under the Mod Rehab program, PHAs were required to establish rents for the units to be assisted based on the costs of amortizing the loan for the rehabilitation work added to the basic costs of owning, operating and managing the property.

- When financing included coinsurance, the lender established mortgage insurance processing rents, which are required to be the lesser of market comparable rents or the Section 8 Mod Rehab Fair Market limitations.

- Some coinsuring lenders--and some HUD field offices--incorrectly interpreted the procedures covering HUD fully insured Mod Rehab projects as being applicable to the co-insurance program; accordingly, these lenders set the rents themselves, as agents of HUD. On the other hand, except in isolated cases, the Department did not change its instructions that PHAs were to carry out the PHA responsibilities for setting Mod Rehab Section 8 contract rents.

- Audits of coinsured lender activities in the Mod Rehab program have alleged that Mod Rehab rents established during this period by such lenders were excessive for several reasons (i) rehabilitation work which would have been ineligible in the Mod Rehab program was included in the mortgage and rent calculations, and (ii) inflated comparables were used -- also contributing to higher mortgage amounts and excessive Section 8 rents. In 10 projects audited, the OIG estimated that millions in excess Section 8 subsidies would be paid out over the 15-year life of the HAP contracts.

- In January 1988, the Department issued explicit clarifying instructions; Mod Rehab Section 8 contract rents in coinsured cases were to be the lower of the PHA's cost-based rent calculations or the comparable rent established by the coinsuring lender. Subsequently, in May 1989, the insured processing procedures were made applicable to coinsured Moderate Rehabilitation projects but with the HUD field office, not the coinsurer, being responsible for setting the Section 8 contract rents.

What Went Wrong with Coinsurance

The coinsurance program did not attract experienced and well capitalized lenders for a number of reasons including: (a) loose entry standards and procedures; (b) inadequate HUD staffing, mortgage product quality and service; and (c) domination of the industry by a few coinsurers whose practices of overmortgaging drove out many of the better lenders. When patterns of overmortgaging by DRG and a few other lenders were discovered, HUD lacked the political will to ban them from the program -- thereby encouraging the overmortgaging practices. Eventually three coinsuring lenders defaulted on their GNMA pass-through obligations. GNMA was forced to assume their troubled portfolios and commence costly and time consuming foreclosure and disposition procedures.

Some of the key remaining program problems are summarized below:

1. HUD Program Deficiencies

-- Lax coinsurer entry standards.

-- Loose underwriting requirements.

-- Insufficient developer cash in new projects.

-- Inadequate HUD staffing (and lack of critical skills: e.g. CPA's and appraisers).

-- Absence of program goals (program financial performance) and information to monitor the achievement of program goals.

-- Limited, non-competitive mortgage products (e.g. 35 year paper requiring higher interest rates for GNMA investors); and lack of adequate customer service.

2. Insufficient Quality of Coinsurers

-- Portfolios are generally too small and generate insufficient servicing income (only 17 basis points) to be self-sustaining.

-- Lenders' capital and liquidity levels are too low to withstand even a small number of serious defaults.

-- In addition to 10 already sanctioned coinsuring lenders, there are others whose performance may warrant sanctions.

As a direct consequence of these program and lender deficiencies, the multifamily coinsurance program has experienced unacceptably high default rates. As these defaults evolve into claims, HUD will suffer significant losses in the General Insurance Fund. The following table provides the most current information on defaults and claims.

TABLE 2: COINSURANCE DEFAULTS AND CLAIMS AS OF AUGUST 31, 1989

	Defaults			Claims Paid	
	Projects	Mortgage Amt.	%*	Projects	Amount Paid
Sec. 223(f)	140	$ 800,863,000	13.2	23	$66,895,766
Sec. 221(d)	11	117,612,800	5.1	0	0
Sec. 232	0	0	0.0	0	0
	151	$ 917,475,800	11.0	23	$66,895,766

*Percentage of coinsurance in force.

As disclosed yesterday in the FHA September 1988 audited financial statements, loss reserves in the amount of approximately $960 million have already been established for the coinsurance program. The difference between the $67 million above and the $960 million loss reserve reflects the time lag between a loan going bad and the ultimate claim being paid. This time lag underscores the importance of proper accrual accounting, advocated by Secretary Kemp and GAO to permit early recognition of program problems.

It is informative to compare the coinsurance default rates with those in full insurance. Coinsurance default rates are currently 13.2% for 223(f) (5% excluding DRG's portfolio and defaults) and 5% for 221(d). (Given the newness of the 221(d) coinsured mortgages, the current 5% figure significantly understates the ultimate default rate for that program.) Default rates for fully insured 223(f) and 221(d) projects are respectively 6.9% and 17%. The full insurance loss severity rate for 221(d)(4) during the last two years is approximately 40% and the loss severity rate for coinsured 223(f) projects is 55% (50% excluding DRG). Clearly, these factors show that even in full insurance financing is a risky business requiring great skill.

Corrective Actions Taken to Date

Secretary Kemp has taken a series of actions to assert control over the coinsurance program and to limit HUD's losses.

First of all we have initiated a comprehensive review of the Department's multifamily coinsurance programs. This review has included the following features:

1. Moratorium on New Coinsuring Lender Applications/Approvals

During HUD's review and evaluation of the program, we are not accepting any new applications for approval of coinsuring lenders. There are also restrictions on HUD processing of lender applications received prior to the beginning of HUD's evaluation last May.

2. Expansion of HUD Monitoring

HUD is increasing its remote and on-site monitoring of all existing coinsuring lenders. During the evaluation period, HUD Headquarters and Field Offices are reviewing lenders' processing and underwriting for all coinsured loans. By creating new computer-based systems, HUD is also increasing its capacity to remotely monitor the financial performance of individual coinsured projects.

3. Evaluation of Coinsuring Lenders

HUD is evaluating all active coinsuring lenders with respect to: (a) quality of past and current underwriting; (b) levels of defaults and claims; (c) capitalization and liquidity in relation to portfolio size; (d) credit worthiness; and (e) compliance with other program requirements. The purpose of this evaluation is to identify lenders who should be put under closer scrutiny and/or administrative sanctions (i.e., probation, suspension or withdrawal of approval).

4. Review and Revision of Program Requirements

HUD has engaged the accounting firm of Price Waterhouse to review the coinsurance programs' capital and financial reporting requirements. At a meeting with coinsuring lenders on June 6, 1989, Housing announced that it intends to significantly strengthen requirements in these areas. To the extent that lenders have real and substantial capital "at risk", they should be motivated to underwrite sound loans.

HUD is also reviewing other program features, including the lender approval process; project appraisal and underwriting of coinsured loans; loan management; monitoring and program enforcement. Since the beginning of HUD's evaluation we have issued ten coinsuring lender letters to implement various program changes.

HUD also has increased its enforcement activities with respect to coinsuring lenders who have violated program requirements as follows:

1. Suspension

DRG Funding Corporation has been suspended from participation in all Federal Government programs. Puller

Mortgage Associates, Southwest Funding Group and Concord Mortgage Company have been suspended as coinsuring lenders.

2. Probation

Six lenders (Benton Mortgage Company, Citadel Mortgage Company, Carnegie Evans, L.P., Washington Capital Associates, Integrated Funding, Inc. and Cincinnati Mortgage Company) have been placed on probation for six months. While on probation, these lenders may not issue firm commitments without HUD Headquarters' prior review and approval.

3. Close Monitoring

Three lenders have been notified that their coinsurance underwriting is being scrutinized by HUD because of irregularities detected through remote monitoring. During the 120-day evaluation period, Housing will continue to use its remote monitoring capabilities to identify lenders whose underwriting warrants closer scrutiny.

On July 6, 1989, Secretary Kemp announced that, until further notice, HUD is suspending full insurance and coinsurance for Retirement Service Centers. HUD will honor firm commitments outstanding as of that date, but will permit no new commitments until the program has been thoroughly evaluated and redesigned to serve the needs of low and moderate-income elderly.

Conclusion

Our current review of the multifamily coinsurance programs, as well as earlier audits by HUD's Office of Inspector General, clearly indicates that further policy and structural changes are needed to make coinsurance viable. HUD welcomes any opportunity for dialogue with this Committee as we work to achieve the goal of affordable housing for American families.

STATEMENT OF ALFRED A. DELLIBOVI
UNDER SECRETARY OF HOUSING AND URBAN DEVELOPMENT
BEFORE THE
HUD/MOD REHAB INVESTIGATIVE SUBCOMMITTEE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
MARCH 27, 1990

Mr. Chairman, and members of the Subcommittee, I appreciate this opportunity to appear before you to discuss Secretary Kemp's decision to terminate the coinsurance method of multifamily mortgage insurance delivery and to replace it with a more effective method of providing such insurance. I am accompanied today by Peter Monroe, HUD's General Deputy Assistant Secretary for Housing and Deputy Federal Housing Commissioner, and Robert Kalish, Executive Vice President of the Government National Mortgage Association (GNMA).

As you know, Secretary Kemp's decision to impose pre-commitment loan reviews and propose the termination of coinsurance by rulemaking is currently the subject of litigation. The Department has invoked its deliberative process privilege in that litigation. Thus, there may be issues raised -- particularly those involving disclosure of pre-decisional analyses, recommendations, and opinions -- that we will not be able to address in today's forum.

We recognize, of course, the Subcommittee's legitimate need to pursue its oversight function and will endeavor, as always, to be as forthcoming and as cooperative as possible in responding to your inquiries.

Mr. Chairman, the coinsurance delivery scheme was intended to enhance and create opportunities in which the Government could work in partnership with the private sector to meet new construction, rehabilitation, and refinancing demands of diverse forms of multifamily housing. The concept of public-private partnerships was, and remains, a laudable goal. Designed to share financial risks while effectively addressing housing needs, the coinsurance method delegated to private lenders -- subject to audit, exception, and review by HUD -- the authority to originate, process, and underwrite mortgage loans and to issue firm commitments binding HUD to coinsure those loans. HUD also delegated servicing, management, acquisition, and disposition responsibilities. In return for assuming a portion of the financial risks, lenders collected significant, up-front application, financing, and mortgage insurance premiums.

However novel in its approach or well-intentioned in its goals, the coinsurance scheme proved to be structurally flawed, administratively unfixable, and fundamentally unsound.

A number of undercapitalized and opportunistic lenders -- capable of committing the Federal Government to approximately 80 percent of the ultimate insurance burden -- often inflated mortgage amounts and issued loans which clearly could not be supported by project income. Many of these private lenders secured substantial profits for themselves while leaving the Department, and ultimately the American taxpayer, holding the bag.

Even before the appointment of Secretary Kemp, HUD's Inspector General noted in 1988 that coinsuring lenders were "underwriting unsound loans, failing to detect indications of troubled loans in a timely manner, and were not taking adequate and timely action to minimize mortgage defaults and coinsurance losses."

Predictably, given years of failing to heed the danger signals, the Department soon found itself facing staggering losses resulting from coinsurance defaults. GAO's FHA audit for fiscal year 1988 estimated these losses to be $960 million, "with future losses likely." As of March of this year, the dollar volume of defaulted coinsured mortgages had skyrocketed to more than $1.6 billion, or roughly 18 percent of all coinsurance in force.

While theoretically HUD was liable for approximately 80 percent of the risk associated with those defaults, that burden increased to 100 percent when coinsuring lenders defaulted on their GNMA portfolios, since GNMA is fully indemnified against coinsurance losses by FHA.

In the Fall of 1989, the Comptroller General of the United States Charles Bowsher, appearing before the House Subcommittee on Housing and Community Development to review FHA's 1988 financial statements, noted that "because of the basic weaknesses in the multifamily coinsurance programs, involving inadequate levels of capital and deficient coinsurance monitoring, it is possible that still more coinsurer defaults may occur and cause additional losses of unknown magnitude."

At that same hearing, Tom Craren, a partner of Price Waterhouse, said of the coinsurance program "we think there was a motivation to grow without regard to the quality of that growth, and as a result, FHA had concentration in the program." Craren added, "They (FHA) had a couple of coinsurers that were leveraged to the degree of 40 to 1, and that creates a tremendous risk for any program, and if a large coinsurer goes down, which one did, a big one, DRG, it costs you a lot of money. So, it was structurally flawed from the start. We said that."

Despite these clearly fundamental and ultimately fatal flaws in the delivery mechanism, Secretary Kemp felt it was prudent to conduct a fair, far-reaching, and reasoned evaluation of coinsurance.

HUD's Office of Policy Development and Research reviewed the premium structure of coinsurance programs; considered options for increasing insurance fees; analyzed capital and liquidity requirements for coinsuring lenders; compared coinsurance claims with those of full insurance; and assessed the impact of coinsurance on rental housing production.

HUD's Office of Housing solicited recommendations for regulatory and administrative changes from HUD staff at all levels as well as from industry groups such as the Mortgage Bankers Association, Housing Study Group, and individual coinsurers. Using data submitted by coinsurers, FHA staff assessed levels of risk in the portfolios of all active lenders on the basis of defaults, occupancy, average monthly operating deficits, and remaining operating deficit escrows.

Price Waterhouse, in a comprehensive study ordered by Secretary Kemp, found HUD's current capital requirements seriously inadequate, with average lender exposure showing a leverage factor of roughly 18 times minimal system capital -- an exposure level that "does not compare favorably to standards applied by banks and by the Fannie Mae DUS program, nor the risk-based capital guidelines contemplated by FIRREA."

I should point out that under coinsurance -- unlike the Fannie Mae DUS program -- all capital loss reserves are held by the lenders rather than by HUD. Even if HUD could have implemented higher capital requirements -- coinsurance regulations prevent HUD from making such requirements -- the additional new capital generated would not have been sufficient to protect HUD from the damage already done by numerous poorly-underwritten loans.

Secretary Kemp also placed a moratorium on new lender entrants while reviewing the coinsurance method and exploring ways to improve its operation. He suspended seven lenders, and placed six others on probation. GNMA seized the portfolios of five coinsuring lenders who defaulted under its mortgage-backed securities program. These portfolios of defaulted lenders represent more than $1.8 billion in coinsurance mortgages, of which $883 million are in default.

Secretary Kemp's prudent decision to propose the termination of coinsurance was built upon an undeniably strong foundation of well-documented flaws: audit reports by HUD's Inspector General and GAO; the Price Waterhouse study and the vigorously expressed rejection of its proposed capital requirements by a substantial body of coinsuring lenders; the Department's internal control reviews pursuant to the Federal Managers' Financial Integrity Act of 1982; extensive internal reviews by HUD staff nationwide; the increasing and staggering rates of defaults; and the glaring structural deficiencies of the coinsurance program.

One industry observer, in a recent article on DRG, summed up some of these structural flaws: "Under the coinsurance program the federal government was putting its full faith and credit behind lenders that stood to benefit from the fees, developers that stood to benefit from the loans, appraisers that stood to benefit from continued business as long as they corroborated the developers' valuations, and underwriters that stood to benefit from processing deals as quickly as possible."

Mr. Chairman, despite the inherent soundness of the decision to initiate actions to terminate coinsurance, Secretary Kemp remains fully committed to continuing HUD's role as an insurer of loans for the development of affordable multifamily housing.

First, HUD's traditional full insurance programs will continue to be available for the same types of projects that might have sought coinsured financing.

Second, we are allowing coinsuring lenders who have not been suspended to continue to process loans and issue commitments, subject to pre-commitment review and approval by HUD. The Secretary believes that these pre-commitment reviews are essential to protect HUD from further losses because of improper underwriting while enabling lenders to continue making financing available for needed housing.

Third, and most importantly, HUD intends to supplement the current full insurance program by developing a new delegated insurance processing system. The Government expects to underwrite all new insurance commitments and assume the entire default risk, in return for 100 percent of the insurance premiums paid by the borrower. Private lenders will be expected to conduct processing and servicing functions and will receive competitively determined fees.

To participate in the new delegated processing program, lenders will be required to meet certain HUD staffing, organizational, and procedural requirements. We recognize that many coinsuring lenders have made considerable investments in staff and organizational capacity. Those coinsuring lenders who are, and remain, in good standing should be well-positioned to participate in the new program when it is implemented.

In closing, I would like to convey to the Subcommittee Secretary Kemp's strong belief that a sound mortgage insurance program is critical to our goal of providing affordable housing to low and moderate income Americans.

Thank you, Mr. Chairman and we look forward to responding to your questions.

Statement of

Dr. Robert H. Edelstein

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and
Co-Chairman
Center for Real Estate & Urban Economics
Walter A. Haas School of Business
University of California at Berkeley

Before the

HUD MOD Rehab Investigation
Sub-Committee
of the Senate Committee
on Banking, Housing, and Urban Affairs

Hearings on

HUD's Multi Family Mortgage
Co-Insurance Program
and GNMA's Related Mortgage Backed
Securities Program

Tuesday, March 27, 1990

Mr. Chairman, and Members of the Subcommittee:

I thank you for the opportunity to come before your Committee to present my views about the problems and potential solutions for HUD's Multi-Family Mortgage Co-Insurance Programs, under Sections 221(d)4 and 223(f).

My remarks are predicated on the assumption that there is a significant need for the financing of low- and moderate-income new and existing multi-family housing that will not be filled by the private sector; and a program of loan insurance is necessary to create and maintain a viable secondary market outlet for these loans. Capital resources for multi-family housing over the past four decades have always been volatile. The sources for low- and moderate-income multi-family housing loans in the foreseeable future are likely to be especially constricted. First, life insurance companies, pension funds, and other institutional lenders tend to prefer the "high-quality" end of the multi-family market. Second, thrift institutions because of their generally dismal fiscal circumstances and new FIRREA regulations for risk-based capital requirements are likely to withdraw significantly from multi-family lending. Third, at the end of 1989, the FHLMC, a traditional source for moderate-income multi-family housing loans, has altered its regulations for such loans, thereby reducing likely loan purchase activity in the future. Fourth, the loan programs of FNMA, some of which, though similar to the HUD co-insurance programs, also have certain limitations that will effectively curtail their growth. Finally, if HUD discontinues its co-insurance program, I believe the low- and moderate-income multi-family housing loan market will be decimated.

One school of thought suggests that the programs and concepts of loan co-insurance are "structurally flawed and fundamentally unsound as well as administratively unfixable." This position, I believe, is erroneous. To the contrary, co-insurance may be the only reasonably viable and efficient method by which the Federal Government can be involved in the delivery of loans for low- and moderate-income multi-family housing. While egregious performance of the existing multi-family loan co-insurance programs is well-documented, the desire to terminate the co-insurance approach might be considered analogous to "throwing the baby out with the dirty bath water."

My testimony will provide an overview of co-insurance and the instruments necessary to design, implement and monitor a successful loan co-insurance program. My comments will be divided into three sub-areas: first, I will address the issue of legitimacy of the co-insurance concept; second, I will discuss the interrelationships among real estate projects, investor-owner-developer risks, lender risks, and government and private sector co-insurer risks; and third, I will delineate how a co-insurance program must undertake risk management control, and will recommend specific elements of the existing Government co-insurance underwriting-monitoring system that need changes.

Is Coinsurance Conceptually Flawed?

In brief, the coinsurance loan concept is preferable to full insurance of loans. Full insurance loan programs require that FHA underwrites and monitors the real estate project performance, the timely payment of loans, and ultimately bears the risks of either the market for real estate declining, inept project management or lender malfeasance. In a 100% loan insurance program FHA-HUD bears additional risks relating to behavior disincentives. First, there is moral hazard, i.e., developers, real estate investors, and lenders may undertake or conduct business in ways they would not if they were at risk. They do this because their returns can be changed but the risk bearing they absorb does not change commensurately. These situations are obviously dangerous to the insurer. Second, there is adverse selection of projects offered to the 100% loan insurer. To the extent that lenders can differentiate subtle risks of projects in a way that the insurer can not, the lender will insure those projects that are ceteris paribus riskier. The extent that people "playing on the field" can tell more about the ball game than those "observing from the stands," the analogy suggests that FHA-HUD as a 100% loan insurer is likely to confront adverse selection in its loan insurance portfolio.

In principle, coinsurance by placing the lender at risk with the FHA-HUD creates incentives for the lender and FHA-HUD that are in alignment. In these situations, one would want the lender to have a relatively free hand in evaluating and making loan decisions, and loan monitoring over time. The lender should handle defaults and foreclosures, abstracting from criminal behavior, in order to maximize recoveries from losses. This does not mean that FHA does not need to conduct underwriting, monitoring over time, and project evaluation in foreclosure and default. But the lender can provide basic information, and do much of the work with FHA-HUD overviewing the process knowing that the lender has sufficient risk sharing incentives and resources at risk. In fact, properly structured and implemented loan coinsurance should reduce both moral hazard and adverse selection problems.

As has been well documented in prior hearings, it is clear that FHA-HUD abrogated its responsibility for underwriting and monitoring; such behavior will lead to the failure of any program. The failure to conduct basic underwriting and monitoring responsibilities can not be claimed to be a systematic cause for the failures and losses of the coinsurance program.

Real Estate Asset Performance, Project Financial Risk, and Co-Insurance Lending Risk

A real estate lending co-insurance program must focus upon the management and control of its financial risks. These risks are dependent upon the underlying risks of the real estate assets and the financial structuring of the real estate transaction. Exhibit 1 illustrates the sources and relationships among real estate project risks. The first distinction is between business and financial risks. Business risk is the underlying asset risk -- the probability that the expected level and pattern of cash flows will not be received. Business risk ignores financing variables. Business risk can be translated into the probability that the expected or required rate of return will not be realized; and is caused by changes over time in five real estate economic variables: capital expenditures, gross possible income, vacancy and credit losses, operating expenses, and property value. The greater potential variance in these five variables, the greater the business risk. After-tax cash flows are affected by changes in income and capital gains taxation, which, in turn, affects business risk. Conceptually, business risks can be further divided into static and dynamic risks. Static risk is related to physical cause and effect, occurs at random, and is beyond the control of the investor. Static risk always results in a loss. Examples include damage to property caused by fire, storm, or flood, or losses caused by personal injury, theft, or "malicious mischief." Normally, these risks can be insured against because they are predictable over the long-run. Consequently, most investors shift these risks by entering into an insurance contract with a property or casualty insurer.

Dynamic risks, in contrast, can mean either profit or loss. Dynamic risk is related to changes in general business conditions and the physical conditions of the property. It is related to the market demand and supply conditions, the age of the property, the quality of the property management, changes in the economic base and the local environment, tax reforms and so on. Changes in these factors could cause changes in the purchase price, the net operating income, the value of the property, and/or tax benefits to the investor, and thus affect the rate of return.

Financial risk refers to the risks to the investor created by debt financing, and is affected by business risks. It increases whenever the amount of debt service increases, and visa versa; financial risk is the probability of not receiving the expected or required rate of return owing to the investor's inability to meet fixed financial obligation created by debt servicing. Since financial risk is essentially a cash liquidity or solvency problem, it can be caused by either internal or external factors. Internal financial risks relate to the ability of the project to generate enough cash to pay the monthly or yearly debt service. For example, if the debt coverage ratio[1] is low because of a high leverage ratio or mortgage constant, the project is characterized by high internal financial risks. If the debt coverage ratio increases, internal financial risk decreases. The second type of financial risk, external financial risk, emanates from the real estate investor's ability to obtain cash in the money markets or other external sources. For example, if an investor can readily finance a cash need of a property using funds from external sources, such as bank loans or additional equity cash investments, the project is said to be characterized by low external financial risks, and vice versa.

Mortgage lending and insuring affect the relationships between financial risks and business risks thereby altering overall risks. For example, if the project does not generate the cash flow that was expected because the marketplace softens, this would be a business risk because the asset did not perform as expected. However, if the project is highly levered, then, the business risk will impact and intertwine with financial risk and intensify the overall project risks. In essence, the project overall risk to the investor increased because of the combination of high leverage and bad asset performance.

In this light, mortgage lenders and insurers must carefully evaluate and understand the interrelationships among financial risks and business risks and the overall risk as seen by the real estate investor and each of the lenders-insurers. This is best accomplished by the lender assessing jointly the credit-worthiness of the borrower-real estate investor and financial quality of the real estate asset. Since real estate is a "local" business, the loan originating lender in the local marketplace is uniquely situated to determine the overall risks of the loan. Loan co-insurance, if properly structured, provides risk protection to the lender, while maintaining adequate lender loss risk-sharing to assure his appropriate performance (i.e., avoids moral hazard and adverse selection problems); as well as creates loans that have sufficient credit-quality to be salable in the mortgage secondary markets.

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[1] The debt service coverage ratio is defined as net operating income divided by debt service; the leverage ratio is represented by the loan-to-value ratio or the debt-to-equity ratio.

Risk Management Control and Co-Insurance Risk-Sharing

Successful real estate (and other) investors know how to manage and control risk, the fundamental idea being not to avoid risks, but to be skilled at identifying it, coping with it, and living with it. Real estate investors who remain in business never risk more that they can afford to lose, never risk a lot for a little, and always consider the odds. These same principles need to be used by a private or public sector real estate lender-insurer. For the loan insurers are ultimately taking the risks that the other real estate investor and/or lenders are attempting to shed. Hence, understanding the process of real estate investment is crucial, and understanding how to manage these risks and control them is paramount to a successful loan insurance program.

The severe loss experience of the co-insurance loan program is the resultant of risk mis-management at three inter-dependent levels: (1) financial structure of risk-sharing, (2) program implementation, and (3) operation design. I will address what changes are needed in each of these areas for the co-insurance loan program.

Financial Structure of Risk-Sharing The principal functions of the financial structure of risk-sharing in the co-insurance loan program should be loss control for both HUD and the lenders as well as the establishment of optimal incentives for all actors as necessary to achieve program objectives. The risk-sharing incentives should (i) encourage lenders to utilize the program to issue high-quality loans (in situations where otherwise they might decline loans or issue loans on less liberal terms), and (ii) ensure careful underwriting and accurate parcel appraisal, and (iii) engender efficient loan administration and sound periodic loan performance monitoring.

The experiences of the co-insurance programs indicate that several inter-related aspects of the risk-sharing structure require change. Clearly, unless a stringent "at risk" capital requirement, including liquid assets and pledged accounts, is established, lender loan performance incentives are minimal. Capital "at risk" must be commensurate with the riskiness of loans. Capital requirements should vary with loan size, loan risk, as well as total lender loan portfolio exposure. The co-insurance program should consider implementing "variable" capital requirements related to the loan-to-value ratio or debt service coverage ratio. The enforcement of more stringent capital requirements should reduce HUD's exposure to default loss in the GNMA secondary mortgage market. Finally, the ability to enforce meaningful penalties for violation of these rules (including criminal penalties where appropriate) is necessary to be fully effective.

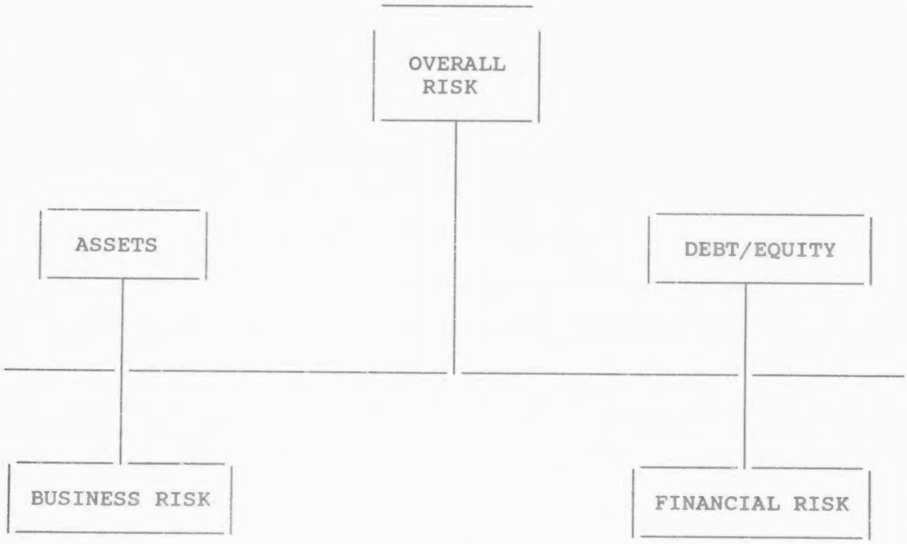
Program Implementation The co-insurance approach is designed to leverage on the underwriting expertise, monitoring capabilities and financial resources of the private financial sector. This does not imply that FHA-HUD does not have significant (though diminished) underwriting and loan performance monitoring responsibilities. It is virtually impossible to design a co-insurance loan program where underwriting (including careful pre-screening of lenders) and periodic monitoring do not have the highest of priorities. Monitoring can be done cost efficiently with random in-depth on-site audits as well as systematic analyses for identified high-probability problem loans. Underwriting and monitoring need to be more intensive just after loan approval and before loan issuance. Random double-checking of appraisals and random auditing-monitoring of capital adequacy of lenders, over time, are also likely to be fruitful uses of limited FHA-HUD resources.

Operation Design If the lender has appropriate risk-sharing incentives, optimal loan loss control would require that both FHA-HUD and the private sector lender have reasonable flexibility to work-out delinquent loans in ways other than foreclosure. While such new flexibility would place an added burden on FHA-HUD monitoring, carefully controlled loan work-out flexibility can reduce ultimate loan loss ratios. Along these lines, FHA-HUD should explore the possibility of partial or interim lender claim settlements, and the temporary waiver of debt service payments.

In summary, the co-insurance loan programs represent an innovative approach by the public sector to benefit from the lending expertise and resources of the private sector. Past program failure was the inevitable result of improper implementation and design. I believe an appropriately altered and recrafted co-insurance loan program can be a viable entity for generating loans for low- and moderate-income multi-family housing.

EXHIBIT 1

THE DETERMINANTS OF REAL ESTATE PROJECT RISKS


OVERALL RISK
ASSETS
DEBT/EQUITY
BUSINESS RISK
FINANCIAL RISK

PREPARED STATEMENT OF THOMAS J. CRAREN

Mr. Chairman and Members of the Subcommittee:

I am Thomas J. Craren, a partner with the accounting firm of Price Waterhouse. I was in charge of the financial audit of the Federal Housing Administration, which was conducted under contract with the U.S. General Accounting Office, and also directed a review of the multifamily coinsurance programs -- a study initiated by HUD. I appreciate this opportunity to appear before the subcommittee.

The FHA Financial Audit

The significant losses and the many internal control weaknesses of the multifamily coinsurance programs first became apparent to us during our financial audit of the Federal Housing Administration (FHA). We recommended, and FHA recorded, additional loss reserves of some $960 million, principally to recognize losses resulting from defaults of three coinsuring lenders, one of which had a particularly large part of the multifamily coinsurance portfolio. Even after recommending this large adjustment, we were not certain it was enough because of the possibility that other coinsuring lenders would also default causing more losses -- losses that could be material to the financial statements. Our concerns about other lender defaults occurring and the additional losses those defaults could cause stemmed from the low levels of required capital, especially for larger lenders whose coinsurance exposure was many times their capital base, and because of deficiencies in HUD's monitoring and surveillance capabilities. We understand that since the completion of our audit, two more coinsuring lenders were declared in default by HUD.

Review of the Coinsurance Programs

In addition to our financial audit work for GAO, HUD asked us to perform a more detailed review of the capital requirements and administrative controls of its multifamily coinsurance programs. The focus of this review was to assist HUD in its evaluation of its internal control structure for its annual report pursuant to the Financial Managers' Financial Integrity Act.

Most of the coinsured mortgages are backing securities fully guaranteed by the Government National Mortgage Association (GNMA), a government corporation operated by HUD and included in HUD's budget. The significance of this point is that once GNMA declares a lender in default of its obligations, HUD, whether through GNMA or FHA, becomes responsible for all losses associated with defaulted lender's multifamily mortgage portfolio, not just the FHA-insured portion.

The full GNMA guarantee increases HUD's risk on coinsured loans and underscores the importance of devoting even more attention and diligence to screening program applicants to whom underwriting functions will be delegated, and closely monitoring them thereafter. And to be most effective, ongoing monitoring should include the ability to identify credit exposure and quantify losses as early as possible so that prompt action can be taken to mitigate excessive losses.

Program Deficiencies

While quantitative standards such as capital and other financial requirements are important to ensuring program commitment and to provide HUD with a cushion against excessive losses, they are naturally arbitrary and, on their own, will not assure fiscal responsibility on the part of all program participants. To be effective, they must be accompanied by sound administrative controls and thorough lender monitoring. However, the multifamily coinsurance programs had many deficiencies in these areas. These deficiencies involved insufficient screening of program applicants, a lack of detailed and reliable financial information about the coinsuring lenders and the individual loans they insured, and a lack of sufficiently experienced personnel to perform more thorough field monitoring and to analyze more detailed and comprehensive financial information.

While these problems are easily stated and seem straightforward, developing solutions to them is complicated. Designing and implementing methods of efficiently collecting additional information and systems to process and analyze it is often time-consuming. Further, internal development of the staff experience needed to deal with complicated financial transactions of the type involved in these programs could take a long time; particularly if HUD is unable to attract experienced personnel from outside the agency.

GNMA Monitoring

GNMA monitoring of FHA-approved lenders is necessitated by its guaranty of securities backed by FHA-insured mortgages. While the focus of its monitoring is on those areas most important to ensuring timely pass-through payments to security holders, GNMA has generally been the first HUD organization to identify and deal with problem coinsuring lenders. GNMA's monitoring system is well developed, giving it the ability to collect monthly financial information about the GNMA security pools, to review this information analytically, and to target problem lenders for further scrutiny. Through the use of a contractor, GNMA can also perform frequent on-site reviews of its issuers, many of whom are FHA-approved lenders.

But GNMA's monitoring system is not meant to and does not provide information about FHA's credit exposure. Nevertheless, in upgrading its monitoring capabilities, FHA can benefit from GNMA's experience and, at the same time, develop a way of coordinating its monitoring efforts with those of GNMA.

Loss Recovery on Defaulted Coinsured Multifamily Loans

Another issue is how to recover a greater portion of claims paid on defaulted coinsured loans, particularly loans originated before program improvements were put into place. HUD's recovery of losses on these defaulted loans has been poor; but this may have resulted more from poor underwriting at origination than from particular problems in the disposal of the foreclosed property. While it is important to obtain the best possible price when foreclosed properties are sold, and to avoid excessive holding and interest costs in doing so, HUD's ability to significantly improve its recovery rate is constrained if, at origination, the value of the property was overstated and thus provided less collateral relative to the size of the loan. Recovery rates can also erode if economic conditions or other factors, such as property disrepair, caused declines in the property value. Either situation would probably be reflected in low recovery received once the loan defaulted and the foreclosed property was sold. The best way to avoid severe losses and low recovery rates is to ensure, through a proper appraisal at origination, that the loan is reasonable in relation to the value of the mortgaged property. Periodic monitoring thereafter could identify declines in property values for other reasons, and would help facilitate prompt action to minimize losses.

* * * *

My discussion of the many problems in the multifamily coinsurance programs was brief and may lead to the presumption that they can be easily solved. But correcting program flaws, modernizing financial and monitoring systems, improving internal control practices and procedures, and building staff experience is something that cannot be done overnight. And if major program flaws cannot be promptly corrected, HUD continues to be exposed to significant losses. I believe HUD management has done a thorough analysis of the problems with which it is confronted, and has begun to put a new structure in place that will ensure its programs are run properly and in a cost effective manner.

Statement of

Chris Greer, Assistant Inspector General for Audit

Department of Housing and Urban Development

Before the Subcommittee on HUD/Mod Rehab Investigation

United States Senate

March 27, 1990

Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to join this panel to provide our Office's perspective on the issues being discussed today.

On several occasions over the past year, Inspector General Paul Adams has testified before Senate and House subcommittees on the subject of coinsurance. We are submitting today, for the record, a copy of Mr. Adams' most recent written statement (September 28, 1989, before the Senate Committee on Banking Housing and Urban Affairs) that summarizes our efforts through September 1989.

The Statement describes our various internal and external reviews that pointed out basic flaws in the design of the coinsurance program, as well as in program delivery, by coinsured lenders and HUD staff. The flaws were pervasive and exposed HUD to significant losses due to fraud, waste and mismanagement.

Since September, our staff has consulted often with Housing staff and officials on potential corrective actions that would resolve the problems noted in our audit reports. We consider the recent actions taken to terminate the program to be appropriate from our perspective. We believe the Department needs time to design a program and to assure that appropriate resources in terms of staff and management controls are available to operate the program. We will continue to work with Assistant Secretary Fitts and her staff to effect needed changes.

This concludes my remarks and I appreciate your attention.

Statement of
Paul A. Adams, Inspector General
Department of Housing and Urban Development
Accompanied by Chris Greer, Assistant Inspector General for Audit
Before the Committee on Banking, Housing, and
Urban Affairs
United States Senate
September 28, 1989

Mr. Chairman and Members of the Committee, I appreciate the opportunity to discuss our Office's efforts over the years in pointing out ways to improve the Department of Housing and Urban Development's (HUD's) administration of the Coinsurance Program. Accompanying me today is Chris Greer, Assistant Inspector General for Audit.

The Coinsurance Program, by its very nature, contains numerous complex issues and technical features that are not easy to learn or to understand. However, we believe the management issues we will discuss today are not that complicated. The Coinsurance Program concept was put in place at HUD during 1983. Basically, the Program calls for mortgage lenders to perform all functions relating to loan approval, independent from HUD. In exchange for the autonomy and the loan processing fees of about 4 percent of the mortgage amount, lenders accept responsibility for dealing with defaulted mortgages and ultimately share any losses incurred in the event of foreclosure. For example, the lender assumes the first 5 percent of any loss and shares 15 percent of any remaining loss with HUD.

The Office of Inspector General's basic responsibility under the Inspector General Act of 1978 is to provide guidance and make recommendations for promoting economy, efficiency, and effectiveness, and preventing fraud and abuse. In this regard, our Office has had input into the program since its inception.

During the Summer and Fall of 1983, as part of a Front End Risk Analysis, a system established by our Office to identify needed internal controls, we provided comments to program staff for establishing guidelines for monitoring and taking enforcement actions to reduce HUD's vulnerability to losses. Management agreed to include such controls in the coinsurance program.

Because of the inherent vulnerabilities associated with this totally new program, our Office decided to perform an audit shortly after program activity started. Our first report was issued in November 1985 and, on at least five occasions since, we have reported to HUD management that program improvements were needed. We are attaching excerpts of each such report for the record. The audits consisted of two reviews of program operations through the internal process, and two external audits of individual lender performance. A summary of the audit activities, our reports, and management's reactions follows:

Our first audit started in October 1984. We concluded that inappropriate lender underwriting practices caused inflated mortgages. For the eight specific projects we reviewed with coinsured loans of $115 million, we estimated that the mortgages were excessive by $36 million. HUD management did not agree with our assessment of the program. They characterized our findings as unfair and unjustified since the lender shares in any loss and no foreclosures had occurred.

To overcome the deficiencies noted during our audit, we recommended several measures to improve HUD's control over loan amounts and potential losses. In response, Housing officials stated that the controls we suggested were too strict and would impair the coinsurance concept. As an alternative, they agreed to improve their lender monitoring processes and enforcement actions.

A second internal audit was started in June 1987, about 18 months after the first report. The audit was designed to follow up on the previously reported underwriting deficiencies that caused inflated mortgages and to evaluate lender loan servicing. We found continuing significant problems in loan underwriting. We also concluded that lenders were not aggressively servicing loans. At the time of this audit, unlike the first one, many loans had defaulted (106 or 13 percent of all loans). In our report dated December 9, 1988, we recommended major revisions to the structure of the program and strengthening HUD's posture regarding enforcement activities. Again, HUD management's reaction to our report was basically that we were overstating the nature and extent of the problems. While they agreed to improve some controls, they disagreed with those recommendations dealing with program design changes.

Shortly after Secretary Kemp took office, we briefed him and his staff on several of our major concerns. Coinsurance was one of those concerns. The new management team has taken many actions to address the program's problems, including the recommendations in our audit report. Program staff have completed a comprehensive evaluation of the coinsurance programs that will result in major program changes. Since April of this year, HUD has already initiated the following actions:

(1) Moratorium on new coinsuring lenders.

(2) Expansion of HUD monitoring, including a review of all coinsured loans and projects.

(3) Evaluation of all active lenders, including underwriting, defaults, capitalization, and compliance with program requirements.

(4) Review and revision of program requirements, including lender approval process, project appraisal, loan underwriting, loan management, monitoring and enforcement actions.

(5) Increased enforcement actions, including suspension of four lenders, probation for five lenders, and close monitoring of three more lenders.

(6) Suspension of the coinsured Retirement Services Center Program.

(7) Reorganization of the coinsurance function.

Prior to the reforms just mentioned, our Office also performed external audits covering two of the largest lenders. We reported problems concerning DRG Funding Corporation on January 28, 1988, and recommended to the former Assistant Secretary for Housing that DRG be precluded from making any additional loan commitments until they correct their underwriting weaknesses.

At the time of our report, 79 of DRG's 272 coinsured loans (29 percent) were in default. DRG's defaulted loans amounted to nearly $538 million, or 77 percent of all defaulted coinsured loans.

DRG management practices disregarded HUD's underwriting requirements contributing to its high default rate. The practice increased both its own and HUD's risk of loss. For 11 loans on which DRG had submitted claims at the time of our audit, HUD estimated its eventual loss at about 55 million dollars. More recent data through mid-September 1989 shows that 20 DRG claims were paid or are in process with an estimated loss to HUD of $88 million. Program-wide there were 30 claims submitted with an estimated loss to HUD of $111 million. GAO testified yesterday before this Committee that estimated losses in the Coinsurance Program could approach $960 million.

Unfortunately, the former management team at HUD did not respond to our reports in a positive and timely manner. DRG was not suspended from the Program until March 22, 1989--14 months after our audit and after Secretary Kemp and his team came on board. The Government National Mortgage Association, however, had suspended DRG in September 1988 for failing to make required payments to investors. As you know, the Federal Bureau of Investigation is currently investigating DRG.

A second major effort regarding a coinsurance lender was our audit of Benton Mortgage Company. This audit started in April 1988. We reviewed 14 loans for projects receiving Section 8 Moderate Rehabilitation subsidies and found processing problems with each of them. Our March 20, 1989 audit report discusses deficiencies in Benton Mortgage Company's valuation, mortgage credit and architectural review processing resulting in material misrepresentation of mortgage amounts and rents. We concluded that mortgages totaling $75 million for the 14 projects we reviewed were excessive by $22 million. In addition, excessive Section 8 subsidies of $37 million will be paid for these 14 projects over the 15-year contract periods unless HUD now successfully reduces the contract rents. We recommended that HUD's Mortgagee Review Board take appropriate sanctions against Benton. The Board is currently reviewing this matter.

The Benton audit also pointed up significant weaknesses in the Section 8 Mod Rehab Program. Our April 1989 report on the Mod Rehab Program discusses the lack of adequate cost controls when Mod Rehab projects were coinsured. Essentially, HUD allowed the Coinsurers to establish both the Section 8 rental rates and the insured mortgage amounts with little or no HUD oversight. In response to our audit, the Office of Housing issued revised guidance to HUD staff, PHA's and coinsured lenders in May 1989. These new procedures should address prospectively the problems we noted. However, HUD still faces tough decisions in correcting the problems of overinsured mortgages and excessive Section 8 subsidies for about sixty Mod Rehab projects that were coinsured prior to the implementation of the new procedures.

In a related matter, our Office submitted information to the Department of Justice concerning Benton Mortgage Company's activities and an investigation is in process.

In summary, Mr. Chairman, our experience with the program has been rather extensive and our findings were fairly consistent over the years.

Mr. Chairman, our Office is encouraged by the recent actions taken by Secretary Kemp to enforce HUD requirements on the one hand, while taking a hard look at the program's design. We are working with Assistant Secretary Fitts and her staff to effect needed changes.

This concludes my remarks and I appreciate your attention.

SECTION 223(f) COINSURANCE PROGRAM

Excerpted from the Office of Inspector General Report to the Congress for the 6-month period October 1, 1985 through March 31, 1986, p.25

Coinsurance Program

Lender underwriting practices in the Section 223(f) Coinsurance Program did not fully comply with HUD regulations and HUD monitoring was not always adequate to protect HUD interests. Property values and project net income estimated by lenders consistently exceeded supportable market values. Lender estimates of value and net income for eight projects reviewed exceeded our estimates by $42.4 million and $5.2 million, respectively. We estimate that the coinsured loan amounts exceeded the maximum mortgage amounts by $35.9 million. Although HUD monitoring effectively disclosed such unacceptable lender underwriting practices, it was not effective in assuring that lenders complied with HUD requirements.

Lenders requested endorsement for loans that included costs for repairs that were incomplete at loan closing. Seven of eight projects reviewed had $9.6 million in required or proposed repairs that were incomplete at loan endorsement. Lenders did not have adequate procedures to ensure that repairs would be completed on time. Without this assurance, the potential for loss due to delays in achieving sustained occupancy increases HUD's risk.

We recommended that HUD amend appropriate regulations and issue handbook instructions to assure that HUD's interests are adequately protected. (Audit Report No. 86-TS-112-0004.)

DRG FUNDING CORPORATION COINSURANCE ACTIVITIES

Excerpted from the Office of Inspector General Report to the Congress, Number 19, for the 6-month period October 1, 1987 through March 31, 1988, pp.17-18

Past and ongoing audit work in the Section 223(f) Coinsurance Program and a program monitoring review disclosed that DRG Funding Corporation (DRG), a HUD-approved coinsurance lender, is not complying with HUD requirements. DRG approved unsound loans, failed to detect indications of troubled loans, and was not aggressive or timely in minimizing defaults and coinsurance losses. As a result, DRG jeopardized its sound capital resources and failed to reduce coinsurance losses.

As of September 30, 1987, 34, or nearly 12 percent, of DRG's Section 223(f) coinsured loans were in default. This default rate is very high in comparison to the 0.7 percent default rate of other lenders participating in the program. The outstanding principal balance and accrued interest on DRG's defaulted loans exceeded $253 million. As of April 1, 1988, these numbers had grown to 59, or 20 percent, of DRG's Section 223(f) coinsured loans in default, with a value exceeding $364 million. We believe that this high default rate is a direct consequence of DRG's consistent failure to comply with the intent of HUD loan underwriting and servicing requirements. We previously disclosed deficiencies in DRG's performance in our November 1985 audit report on the Section 223(f) Coinsurance Program. In addition, HUD's Office of Housing issued a monitoring report on DRG in 1987 and reported similar deficiencies in DRG's performance. These reports show that DRG continues to employ high-risk loan processing and management practices in the following areas:

- Valuation Rental and Occupancy Analyses. DRG has not complied with HUD mandates requiring the use of market rents and occupancy ratios when estimating net income. DRG's use of higher-than-market rents and occupancy ratios resulted in overestimated net income which, in turn, justified higher maximum insurable mortgage amounts. Consequently, DRG has increased the probability of defaults and the risk of coinsurance losses.

- Completion of Repairs. Repairs and improvements were not properly inspected before loan closing to assure that the work was actually completed as required. Uncompleted repairs and improvements may preclude the owner from achieving the needed rents or realizing the income necessary to meet expenses and loan payments, thus increasing the risk of default. Also, upon foreclosure, uncompleted improvements may lower the disposition value of a project and increase the coinsurance loss.

- Management Analyses. DRC did not perform underwriting management analyses in accordance with program requirements. As a result, DRC did not identify and correct existing management or operating deficiencies before loan endorsement. The unidentified deficiencies resulted in unsound underwriting and early loan defaults.

- Sound Capital Resources. DRC has not consistently maintained the additional coinsurance net worth requirements pertaining to liquid funds. DRC's cash balance for January, February, and May 1987 was under $500,000 and its receivables consisted primarily of funds due from coinsured projects already in default. In addition, the amounts due from related companies are questionable since HUD is not aware of the financial status of these companies and the potential realization of these receivables.

- Acquisition and Disposition. DRC improperly discontinued foreclosure proceedings on a defaulted loan without curing the default. Rather than accepting a deed-in-lieu of foreclosure and filing a claim for insurance benefits, it allowed title to be transferred twice. By prolonging the default period, DRC will substantially increase HUD's payment for accrued interest and project operating and maintenance expenses for any potential claim it files.

Because DRC has consistently failed to comply with or meet the intent of HUD loan underwriting and has not minimized defaults or insurance loss amounts, we recommended that the Office of Housing take appropriate administrative action to prevent DRC from issuing any further loan commitments until such time as it corrects its underwriting practices and implements effective loan management procedures.

On April 14, 1988, HUD imposed restrictions on DRC's processing and underwriting pending resolution of questions concerning DRC's ability to meet FHA and Government National Mortgage Association capital requirements for continued approval. The restrictions imposed consist primarily of processing and underwriting reviews by HUD of DRC's processing/underwriting of proposed loans, and reviews of proposed issuances of Mortgage-Backed Securities backed by coinsured loans.

SECTION 223(f) COINSURANCE PROGRAM

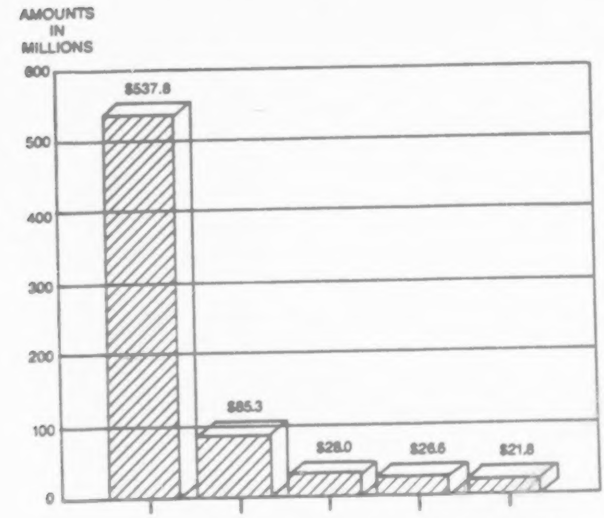
Excerpted from the Office of Inspector General Report to the Congress, Number 20, for the 6-month period April 1, 1988 through September 30, 1988, pp.12-15

We audited the Section 223(f) Coinsurance Program to determine whether lenders were effectively carrying out their delegated responsibilities, and HUD was effectively monitoring and enforcing lenders' compliance with program requirements. The audit focused on three of the 55 lenders participating in the program, ABC Financial Services, Inc. (ABC), DRG Funding Corporation (DRG), and York Associates (York). Together, DRG and York processed 543 coinsured loans, or about 66 percent of all Section 223(f) coinsured loans underwritten as of May 31, 1988. As of that date, participating lenders had underwritten 826 Section 223(f) coinsured mortgages originally valued at about $4.8 billion.

The most serious deficiencies detected during our audit involved DRG. We found that DRG was not adequately complying with HUD's coinsured loan underwriting and servicing requirements. DRG was underwriting unsound loans and failing to detect indications of troubled loans in a timely manner. Additionally, DRG was not taking adequate and timelv actions to minimize mortgage defaults and coinsurance losses. HUD's enforcement of program requirements has not been adequate and has not ensured the prompt and effective correction of lender deficiencies.

As of May 31, 1988, 106, or 12.8 percent of all coinsured mortgages, had defaulted. This compares with a default rate of 0.5 percent in HUD's Full Insurance Program as of July 31, 1988. However, the program default rate would be about 5 percent if DRG's program activity were excluded. The outstanding principal and accrued interest balance on the 106 defaulted mortgages amounted to nearly $700 million. As of September 7, 1988, insurance claims had been submitted to HUD for 21 defaulted loans and will require an estimated payment by HUD of about $61.4 million. DRG's financial difficulty compared to other lenders participating in the program is illustrated in the chart on the following page.

Section 223(f) Coinsurance Program
Principal and Accrued Interest Outstanding
Loans in Default By Lender
As of May 31, 1988



	DRG	YORK	GMAC	DENTON	SOUTHWEST
PRINCIPAL	$511.8	$80.2	$27.8	$26.2	$21.5
INTEREST	26.0	5.1	.2	.4	.3
TOTAL	$537.8	$85.3	$28.0	$26.6	$21.8

As shown in the chart above, the principal and accrued interest balance outstanding on DRG's defaulted mortgages totaled nearly $538 million, or about 32 percent of the original value of all of its Section 223(f) coinsured mortgages. Many of DRG's shortcomings were previously identified by HUD's Coinsurance Division and our office through earlier reviews. However, we found during the current audit that these shortcomings had not been adequately addressed by the lender.

In addition, HUD is currently attempting to eliminate the overmortgaging of properties by coinsuring lenders. But, while HUD has authority to suspend or terminate a lender for departing from approved procedures, it had not taken such actions at the time of our audit. HUD has also been reluctant to exercise its authority to suspend or terminate lenders for serious infractions due to the potential adverse impacts such sanctions may have upon the lenders' financial positions and the Coinsurance Program. Rather than implement strict program enforcement measures, HUD has relied on its internal monitoring of lenders to detect problem areas and to achieve cooperation from lenders in correcting such problems. However, HUD's monitoring effort cannot be successful without the application of program enforcement measures.

In our draft report, we recommended that HUD revise its regulations and instructions in a number of specific areas to better protect the Department's financial interests and to ensure the fiscal soundness of the Section 223(f) Coinsurance Program. Since the completion of our audit, the Government National Mortgage Association has terminated DRG's participation in the Mortgage-Backed Securities Program which in effect eliminates DRG from the Coinsurance Program. Management from the Office of Housing is currently reyiewing our draft audit report and has not yet responded to our proposed recommendations.

SECTION 223(f) COINSURANCE PROGRAM

Excerpted from the Office of Inspector General Report to the Congress, Number 21, for the 6-month period October, 1988 through March 31, 1989, pp.13-14.

On December 9, 1988, we issued the audit report on the Section 223(f) Coinsurance Program. The audit focused on 3 of the 55 lenders participating in the program: ABC Financial Services, Inc., DRG Funding Corporation, and York Associates. Together, DRG and York had processed about 66 percent of all Section 223(f) coinsured loans underwritten at the time of our audit. As of about February 1989, approved lenders had underwritten about $6.7 billion of Section 223(f) coinsured loans.

Section 223(f) of the National Housing Act authorizes HUD to insure mortgages executed for the purchase or refinancing of existing multifamily housing projects. Section 244 of that Act authorizes HUD to coinsure such mortgages pursuant to a contract with an approved coinsuring lender. Once approved by HUD, the coinsuring lender must agree to abide by all applicable requirements imposed by HUD and agree to perform all of HUD's normal loan underwriting functions, among other functions. The lender bears the first 5 percent of each loss on loans it originates. Any further losses are split 85 percent and 15 percent between HUD and the lender, respectively.

Our audit disclosed that coinsuring lenders were not adequately complying with HUD's coinsured loan underwriting and servicing requirements. Lenders were underwriting unsound loans, overmortgaging properties, failing to detect indications of troubled loans in a timely manner, and were not taking adequate and timely actions to minimize mortgage defaults and coinsurance losses. At the time of our audit, 106, or nearly 13 percent of all Section 223(f) coinsured loans, had defaulted. The outstanding principal and accrued interest balance applicable to the 106 loans amounted to nearly $700 million.

While HUD has taken aggressive actions to improve its monitoring of coinsuring lenders' performance, more effective controls and enforcement efforts are needed to enhance the Department's capacity to achieve corrective action by lenders in a more timely manner. HUD's failure to enforce program requirements in a more vigorous fashion is adversely affecting the success of the Section 223(f) Coinsurance Program in preserving existing rental housing and in ensuring the timeliness and quality of lenders' loan underwriting. HUD is also incurring substantial losses in the program and will continue to do so in the future unless more aggressive enforcement measures are taken. These internal control weaknesses are material and were reported as such under the Federal Managers' Financial Integrity Act in the December 31, 1988 report to the President. They should be again reported in the December 31, 1989 report.

The most serious deficiencies detected during our audit of the Section 223(f) Coinsurance Program involved DRG Funding Corporation. At the time of our audit, 79, or 29 percent of DRG's 272 coinsured loans were in default, encompassing nearly 32 percent of the original value of its Section 223(f) coinsured mortgages. The outstanding principal and accrued interest balance on DRG's defaulted loans amounted to nearly $538 million, or about 77 percent of the total principal and accrued interest balance outstanding on all defaulted Section 223(f) coinsured loans at the time of our audit.

Our audit disclosed that DRG was employing high-risk loan processing and management practices in almost every phase of its operations. Consequently, DRG's disregard of HUD's underwriting requirements contributed to its high default rate and substantially increased both its own and HUD's coinsurance risk. For just 11 loans for which DRG had submitted claims to HUD at September 1988, about $55 million in claim payments will be required by the Department. HUD estimated that its losses from DRG loans could be in the hundreds of millions.

In September 1988, the Government National Mortgage Association (GNMA) terminated DRG's participation in the Mortgage-Backed Securities Program, declaring that DRG was in default of its obligations as an approved issuer because DRG failed to pass sales proceeds from disposed projects to GNMA security holders. GNMA was reportedly spending over $6 million monthly to cover the shortfall in debt service payments to GNMA security holders. About $1.1 billion of DRG's Section 223(f) loans were acquired by GNMA and assigned to another lender for servicing.

On January 23, 1989, the FBI executed a court-approved search warrant on DRG. The search warrant application alleged that DRG committed fraud and other offenses against the Federal Government under the Section 223(f) Coinsurance Program and GNMA Mortgage-Backed Securities Program. Documents filed with the court alleged that DRG disregarded HUD regulations, underwrote loans for amounts in excess of the market value of the underlying properties, sold foreclosed properties for substantially less than their value, failed to pass sales proceeds from disposed properties to GNMA security holders, made false statements and certifications to HUD, and misapplied escrow funds. The FBI's investigation of DRG is continuing.

On March 22, 1989, HUD announced that DRG, its affiliates, and 17 named officers/employees were suspended from participating in all Federal housing programs or procurement contracts. The suspension was the result of DRG's irregularities in dealing with GNMA and the Federal Housing Administration as well as allegations of criminal activities, as evidenced by the FBI's investigation of the lender.

On March 31, 1989, the United States District Court for the District of Columbia denied a claim DRG made previously against HUD and dismissed DRG's civil action. On August 5, 1988, DRG had filed a lawsuit against HUD disputing the manner in which coinsurance benefits were paid by HUD. DRG sought a declaration that it was entitled to receive its debentures (coinsurance benefits) with interest from the date of default rather than from the date of settlement of insurance claims. At stake was between $8 million and $9 million in additional interest payments for nine loan claims by DRG.

In addition to the actions taken against DRG, HUD proposed numerous other actions during the reporting period in response to our Section 223(f) report recommendations. For example, HUD proposed to: (1) more vigorously enforce the current regulatory timeframe for acquiring projects after default; (2) publish regulations to revise the amount of accrued interest payable for the period between acquisition and disposition; (3) implement measures providing for financial disincentives for lenders' unsound underwriting and other types of lender noncompliance with program requirements; (4) increase lenders' sound capital resources and liquidity requirements; (5) require lenders to establish and maintain dedicated, funded accounts to accommodate coinsurance losses; (6) publish a policy setting forth the administrative remedies and sanctions HUD will invoke against coinsuring lenders for serious infractions of the Department's coinsurance requirements; and (7) implement a procedure for reviewing lenders' underwriting and property disposition when property sales are below a stated percentage. (Audit Report No. 89-TS-119-0002.)

BENTON MORTGAGE COMPANY

Excerpted from the Report on Benton Mortgage Company, Knoxville, Tennessee, HUD-Approved Coinsurance Lender, Number 89-TS-221-1005, March 20, 1989, pp.i-ii

EXECUTIVE SUMMARY

We examined the books and records of Benton Mortgage Company (BMC), Knoxville, Tennessee, pertaining to its multifamily coinsurance lending activities for assisted projects. The purpose of our examination was to determine if BMC adequately processed Section 221(d) and 223(f) coinsured loans with Section 8 Moderate Rehabilitation assistance.

BMC did not follow prudent underwriting practices and HUD requirements in 14 out of 14 loans tested. Deficiencies in BMC's valuation, mortgage credit and architectural processing resulted in material misrepresentation of mortgage amounts and rents. Since HUD's Section 8 subsidy funds the amount of any excess rent, the deficiencies will seriously impact Section 8 funds. Deficiencies included the following practices.

Valuation Processing

BMC:

- o Substituted superior comparables for those used by BMC's contract appraiser resulting in higher Section 8 rents and a correspondingly higher mortgage.
- o Increased rents with excessive and/or unwarranted rent trend adjustments, often when vacancies were high and rents had declined.
- o Increased rents by misstating data on either the subject or comparable properties to minimize adjustments.
- o Selected their subject rents from the upper range of comparable rents without justification.
- o Increased without justification their contract/staff appraiser's appraised values and thus the replacement cost mortgages, to be consistent with higher debt service mortgages.
- o Processed a project under the wrong program, allowing the developers the maximum mortgage they sought.
- o Treated property purchases as refinancings to justify higher mortgages.

Architectural and Mortgage Credit

BMC:

- o Approved construction contract increases long after added work was completed, and for work already included in the contracts.

- o Allowed mortgagors to use vague work descriptions and specifications, weakening BMC controls over costs and the quality of repair work.
- o Allowed mortgagors to inflate profits through "paper conduit" general contractors.
- o Did not deduct excessive costs from mortgagor cost certifications, e.g., capital improvements funded with rental income, management fees for services performed by the PHAs, and tax credit application fees.

Also, BMC issued a commitment to a mortgagor having a family relationship with the owners of BMC without seeking Headquarters approval.

BMC's noncompliance with HUD requirements and less than prudent underwriting practices inflated mortgages and rents, and will result in excessive Section 8 subsidy. Mortgages for the 14 projects reviewed were excessive by an estimated $22 million, or 29 percent, and Section 8 subsidy will be overpaid by an estimated $37 million over the 15 year life of the Housing Assistance Payment (HAP) contracts. We established the excessive mortgages and rents through reappraisals by eight HUD appraisers working independently. The 14 projects were scattered in 5 HUD regions.

BMC allowed mortgagors to include excessive costs in Section 221(d) mortgages, which inflate the Section 8 rents and HUD's subsidy costs. Excessive profit allowances, improperly approved increases to construction contracts, and ineligible costs have or will result in the ten mortgages reviewed being overinsured by approximately $2.3 million. Our review does not include ineligible costs identified in separate audits of mortgagor and contractor records.

Based on BMC's deficient underwriting we are recommending that the Mortgagee Review Board take appropriate sanctions against BMC.

The findings were discussed with BMC officials and staff during the audit and at an exit conference held January 12, 1989. Subsequently, BMC provided detailed written comments to our draft audit report. We summarized the comments as we deemed appropriate after each finding and in various sections of Appendix B. The entire 53 page response is being maintained in our audit workpaper files. Later, on March 10, 1989, BMC provided a supplementary response and requested that for report purposes the second more general response be included verbatim in the report (See Appendix G).

United Guaranty Corporation
230 N. Elm Street / 27401
P.O. Box 21567
Greensboro, NC 27420-1567
Telephone 919 373-0232
Nationwide 800 334-8966
Facsimile 919-230-1946

UG United Guaranty

STATEMENT OF

UNITED GUARANTY COMMERCIAL INSURANCE COMPANY
JOHN O. BAECKER, REPRESENTATIVE

BEFORE THE HUD/MOD REHAB INVESTIGATION SUBCOMMITTEE
OF THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

MARCH 27, 1990

Thank you for requesting my company's participation in your investigation of the FHA co-insurance program. I hope that what I say today will in some way be helpful.

My name is Jack Baecker. I was President of United Guaranty Commercial Insurance Company, a subsidiary of United Guaranty Corporation and further a subsidiary of American International Group, Inc. (AIG). This past November I elected to take early retirement and currently am self employed as a fee appraiser.

Please let me first give you a little background on United Guaranty Corporation before I address the material requested.

United Guaranty's subsidiaries provide private mortgage insurance to the lending institutions in much the same manner as the FHA. The largest subsidiary is United Guaranty Residential Insurance Company which insures approximately $4.5 billion of residential mortgages annually. This would represent about 43,000 loans on single family houses. The commercial company on the other hand insured about $150,000,000 of mortgages and leases annually representing approximately 200 cases. A significant difference.

The commercial company provided lenders with private mortgage insurance for apartments, nursing homes, warehouses and other income producing properties. We also insured leases on many types of income properties other than apartments.

Unlike the majority of those who will testify here the company did not act as a co-insurer but functioned as a "Re-insurer to the Co-insurer." We were not lenders or originators of mortgage loans. Our sole purpose was to play a secondary role accepting a share of the risk with the co-insurer. We proposed to insure approximately one half of the risk allocated to the co-insurer.

At this time I am pleased to tell you that we did not insure one piece of business for any co-insurer. We were aggressively seeking to do so but, fortunately or unfortunately as the case may be, because of some unusual events our communications broke off. One company was placed on the market for sale by it's parent just as we were about to begin operations and all activity was put on hold. Another's timing was not right as the company decided to forego the program and the third company was put into suspension by FHA.

My personal experience did involve mortgage lending in all aspects. Single family, multi-family, FHA and conventional, construction lending, appraising and the last eighteen years as an insurer nationwide of income producing properties.

That's enough about history.

I've been asked to address the "Risk of multi-family lending and mortgage insuring." There obviously are many. A few basic ones would be concerns about the sponsor (the owner), the builder, the project, and the general market conditions of the area in which the project is proposed.

Concerns regarding the sponsor might be the following:

- What is his current occupation?
- Has he ever owned a project similar to the project proposed?
- Has he the management expertise?
- Has he the finances personally to complete the project?
- Will he be "borrowing out" with little or no capital of his own investor?
- Is the borrower an individual, a partnership, corporation, profit or non-profit entity?

Builder concerns would encompass:

- Experience and expertise to complete the project.
- Has he brought in other projects on schedule and within budget?

Project concerns:

Economic aspects,

- Is the project economically sound?

- Are projected rents market rents or projected "pie in the sky" expectations?
- Are estimated expenses realistic and are reserves sufficient?
- Will a realistic NOI, (net operating income), be available after vacancy, credit loss and expenses?
- Will a NOI/debt service ratio be achieved that will provide a reasonable cushion for unforeseen expenses or changes in occupancy or income?
- Simply put, "Will the dog hunt?"

Physical aspects,

- Is the design compatible with the area?
- Does it blend with the community?
- Are floor plans, (apartment layouts), good, average or poor? (Square rooms vs rectangle, wall space, traffic patterns, closets, storage, etc.)
- Are unit mixes reasonable for the intended market?
- Are recreational and amenity facilities realistic?
- Are parking facilities proper? (Covered or open?)
- Are parking spaces adequate for tenants and guests?
- Is ingress and egress safe and easily accessible?

Appraisal aspects,

- Who is the appraiser?
- Is he Designated?
- What are his qualifications?
- Have all three approaches to value been properly addressed?
- Does the report contain sufficient data to make a decision?

Market concerns:

- Is the project needed?
- Is there currently an over supply or is there a shortage?
- What are the demographics of the community? Growing, stagnant or declining?
- Employment trends.
- Competition, proposed and existing.

This would conclude my thoughts on lending and insuring.

I've been asked to also address "How our company operated in evaluating mortgage insurance risk. How we expected to minimize losses and how we determined the appropriate compensation for the risk associated with mortgage insurance."

Let me address the third part of that question first by stating that when losses begin to occur the compensation is never enough. The MIP, or mortgage insurance premium, as established by FHA and the division of the premium between FHA and the co-insurer didn't leave much for the co-insurer to share with the re-insurer. Which explains why there were not a lot of re-insurers seeking the business.

The company functioned much like a mortgage lending institution, performing similar underwriting procedures and following similar guidelines with a few exceptions.

Evaluating and minimizing loss was expected to be controlled through careful underwriting. Numerous exhibits were required with each application and were thoroughly analyzed. Properties or sites were to be visited and detailed site and market analysis were to be performed for each case.

Loan originators, co-insurers, were expected to submit for our review the following minimum list of exhibits:

- Copy of borrower's application
- Current credit report(s)
- Borrower's financial statement (last three years), signed
- Current D&B if a corporation or equivalent
- Plans and specifications if new construction
- Plot plan
- Contractors bid
- Copy of lender's commitment
- Operating statement for last three years if existing project
- Current signed appraisal (preferably by a Designated Appraiser and containing the following):
    - Current photos of property and area
    - Aerial photos
    - City, neighborhood maps
    - Economic data relating to city
    - Market data, rent and land comparables
    - Copies of all leases

Premium considerations took into account anticipated losses, operating expense and a return on capital. Loss experience was most difficult to judge as the company had no past experience with FHA except Section 8 loans. These of course, had a subsidy that provided a safeguard. The company had virtually no adverse experience with Section 8 financing.

In addition to the above we expected to minimize risk by carefully selecting those we intended to do business with. Furthermore, we made it clear that we would not provide a blanket policy for a client, but would "cherry pick" the portfolio.

I was asked to address the "Flaws in co-insurance as we saw them and further to address our suggestions as to a cure of the flaws" and to comment on "How the FHA might further minimize its risk."

These questions are difficult to respond to in depth for as I previously mentioned we did not actually write any of this business nor did we do as in depth a study of the program as a co-insurer would be expected to do.

However, to minimize risk it would appear to me that FHA needs to become involved earlier in a transaction rather than after the fact. I would suggest:

- Limit co-insurers territorial rights. The advantages are many. An example would be familiarity with the area. Hands on management. Reduced competition between co-insurers.
- Increase liquidity requirements.
- Make "Step-up" mortgages based upon rental achievement
- Create data research personnel locally whose sole responsibility would be to know regional demographics, rental trends, actual building costs, etc.
- Create a workout program to avoid foreclosures when a glitch occurs.

There is not much more that I can add here.

In closing let me thank you for granting us this opportunity to address the committee. Hopefully, some of my comments will prove beneficial. I'll be happy to address any questions that you might have.

Thank you again.

1125 Fifteenth Street, N.W.
Washington, D.C. 20005

Mortgage Bankers Association of America

Ann Hadley vom Eigen
Associate Legislative Counsel
(202) 861-6977

April 13, 1990

The Honorable Bob Graham,
Chairman
Subcommittee on Mod Rehab/HUD Investigations
Committee on Banking, Housing, and Urban Affairs
Washington, D.C. 20510-6075

Dear Mr. Chairman,

At the Roundtable Hearing on the Department of Housing and Urban Development's Coinsurance Program on March 27, the Subcommittee raised concerns about HUD's ability to minimize losses on multifamily properties. You specifically asked that MBA provide the Subcommittee with its recommendations on bankruptcy law reform.

Accordingly, a short summary explanation of proposed amendments to the Bankruptcy Code, as well as the legislative language which would achieve those reforms is attached for inclusion in the hearing record.

We would be happy to respond to any additional requests.

Sincerely,
Ann Hadley vom Eigen
Ann Hadley vom Eigen

Enc.

1125 Fifteenth Street, N.W.
Washington, D.C. 20005

202-861-6500

Mortgage Bankers Association of America

April 13,1990

Proposed Amendments to Bankruptcy Code

The Mortgage Bankers Association of America is deeply concerned about recent developments in bankruptcy law, in which real estate debtors whose asset is a single property in default have delayed foreclosures by initiating proceedings under Chapter 11 of the Bankruptcy Code. These debtors often have no intention or realistic hope of presenting a feasible plan of reorganization in bankruptcy.

In many instances, a mortgagor of a commercial or multifamily property which is in default has filed for bankruptcy under Chapter 11. By initiating bankruptcy proceedings, the mortgagor can (1) delay foreclosure for the indefinite duration of the bankruptcy proceeding without taking any steps to solve the problem,(2)take advantage of various state laws relating to perfection of liens, and prevent the lender from obtaining assignment of the rents from the property while the bankruptcy case proceeds, and (3) toll the progression of state law foreclosure periods in which borrowers are allowed to cure their default.

By taking advantage of these bankruptcy procedures, the mortgagor can thus retain the income from the property for the length of the proceedings, and the mortgagee faces great difficulty negotiating with a borrower to attempt to work out a problem loan.

Consequently, MBA is recommending three changes to the Federal bankruptcy code. The first change would place a limit of 90 days on the automatic stay of foreclosure. The court could extend the stay for an additional 90 day period only for cause. By the end of the first 90 days, the borrower must file a plan of reorganization or commence payments to the lender. Under the second change, assignments of rents would be automatically perfected upon the filing of a Chapter 11 petition. Under the third proposal, foreclosure proceedings initiated prior to the Bankruptcy filing would continue to progress during the bankruptcy proceeding, up to the point of sale.

Amendments to the bankruptcy code which would implement these changes are attached.

LIMITING EFFECT OF AUTOMATIC STAY

Proposed Revision of Bankruptcy Code:

Section 362(d)(2)(B) – Delete "." and add "; or". Add Section 362(d)(2)(C) – in a proceeding under Chapter 11 of this title, if the property is real property, other than residential real property with less than four (4) residential units, which generates substantially all of the gross income of the debtor and on which no business is being conducted by the debtor other than the business of operating the real property and activities incidental thereto, and the debtor has not, within ninety (90) days after the filing of a petition under section 301, 302, or 303 of this title, or of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970 (15 U.S.C. 78 (a)(3)), filed a plan of reorganization which has a reasonable probability of being confirmed within a reasonable period of time, or the debtor has commenced payment to the holder of a claim secured by such real property of interest on a monthly basis at a current fair market rate on the value of the creditor's interest in the estate's interest in such property. The court may extend such ninety (90) day period only for cause and only if an order granting such an extension is entered within the ninety (90) day period.

Statement of Purpose:

The purpose of this revision is to create a disincentive for single asset real estate debtors to initiate proceedings under Chapter 11 when they have no intention or realistic hope of presenting a feasible plan of reorganization. Statistics maintained by the Office of the U.S. Trustee for the past eight (8) years indicate that only 21% of all Chapter 11 proceedings have led to confirmed plans and only 6% to fully paid-out plans. The success rate for single asset real estate Chapter 11s is undoubtedly much lower than the foregoing.

AUTOMATIC PERFECTION OF ASSIGNMENTS OF RENTS

Proposed Revision of Bankruptcy Code:

Section 363(a) -- Add "(1)". Add Section 363(a)(2) -- "For purposes of this section and in a proceeding under Chapter 11 of this title, if the property is real property other than residential real property with less than four (4) residential units, which generates substantially all of the gross income of the debtor and on which no business is being conducted by the debtor other than the business of operating the real property and activities incidental thereto, "cash collateral" shall include an interest in an assignment of rents and leases, whether absolute or intended as security, held by a creditor and duly recorded in the public records, which interest shall be deemed perfected for purposes of this section as well as for all other purposes under this title at the time a petition is filed under sections 301, 302, or 303 of this title, or an application is filed under section 5(a)(3) of the Securities Investor Protection Act of 1970, regardless of whether perfected or unperfected under applicable non-bankruptcy laws.

Statement of Purpose:

The purpose of this revision is to provide for automatic perfection at the time of a Chapter 11 filing of assignments of rents with regard to single asset real estate. Such change would rectify the situation whereby the mere filing of a Chapter 11 petition can preclude a creditor from asserting its claim for rents in that proceeding, and eliminate expensive disputes between creditors as to which creditor had properly perfected and when under differing and often confusing state and federal laws.

A few courts, dealing primarily with Federal entities such as HUD and FmHA as lenders, have held that merely the recording of an assignment of rents or an event of default thereunder constitutes perfection of an assignment of rents and leases for purposes of a bankruptcy proceeding. An affirmative act of possession, such as the appointment of a receiver, is frequently required by state law, however. Unfortunately, it is often just this type of action to perfect an assignment of rents which prompts a borrower to seek the protection of the Bankruptcy Court just as it does on the eve of a foreclosure sale. Once the Chapter 11 petition has been filed, the lender runs up against the automatic stay which prevents such an act of perfection. Although some Bankruptcy Courts permit post-filing perfection under Section 546(c) of the Code, others do not and rents may be long gone by the time relief from the automatic stay has been obtained.

FACILITATING FORECLOSURE FOLLOWING RELIEF FROM STAY

Proposed Revision of Bankruptcy Code:

Add Section 362(i) -- In a proceeding under Chapter 11 of this title, if the property is real property other than residential real property with less than four (4) residential units, which generates substantially all of the gross income of the debtor and on which no business is being conducted by the debtor other than the business of operating the real property and activities incidental thereto, upon request of a party in interest, the court, with or without a hearing, shall grant such limited relief from the stay provided under subsections (a)(1), (a)(3) and (a)(4) of this section, as is necessary to allow such party in interest to proceed during the pendency of the case under this title with a foreclosure proceeding, whether judicial or non-judicial, which had been commenced before a petition was filed under section 301, 302, or 303 of this title or an application was filed under section 5(a)(3) of the Securities Investor Protection Act of 1970, up to but not including the point of sale of such real property.

Statement of Purpose:

The purpose of this revision is to allow foreclosure proceedings to go forward in state or federal court, or nonjudicially, to the point of sale while a Chapter 11 proceeding for single asset real estate is in progress, in order to decrease delays in foreclosure when lenders are granted relief from stay in Chapter 11 cases.

Bankruptcy Courts frequently defer to other courts to allow important litigation to proceed while a Chapter 11 proceeding is in progress. The proposed revision would add to the efficiency of the judicial system by allowing foreclosure actions which have been commenced prior to the filing of a Chapter 11 petition with regard to single asset real estate to proceed simultaneously with the Chapter 11 proceeding up to the point of sale. Foreclosure normally does not involve significant opposition or extensive legal proceedings and thus, the effect of the proposed revision in most cases will be merely to permit a single hearing to take place or to avoid the interruption of a time period which had started to run before the Chapter 11 petition was filed.

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United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, DC 20510-6075

April 12, 1990

Ms. Gaye G. Beasley
Member, Board of Governors

Mr. Warren Lasko
Executive Vice President

Mortgage Bankers Association
1125 Fifteenth Street, N.W.
Washington, D.C. 20005

Dear Ms. Beasley and Mr. Lasko:

I want to thank each of you again for your willingness to contribute to the Subcommittee's review of HUD's co-insurance programs and GNMA's related mortgage-backed securities program. Your participation in the March 27th roundtable discussion was very helpful to the Subcommittee's understanding of these programs and the administrative failures in their design and implementation.

Ms. Beasley, thank you, also, for your letter, dated March 30, 1990, regarding the roundtable discussion and its success. I appreciate your comments very much.

Ms. Beasley, in your oral testimony you indicated that you thought that one of the programmatic flaws with co-insurance was its allowance of loan underwriting based upon project cost limits rather than project value. You specifically referred to the Sections 223(f) and 221(d)(4) programs.

Subcommittee staff have reviewed the program regulations and noted that, with respect to the Sections 223(f) and 232 programs, the mortgage limits are the lowest of several, alternative amounts. The alternative methods of calculation include a limit based upon value and a limit based upon debt service capacity. 12 C.F.R. Sections 252.203 and 255.203. With respect to the Section 221(d) program I am advised that the program regulations vary somewhat from those noted above, but they still require that the loan amount not exceed the lowest of several amounts, including an amount based upon debt service capacity. 12 C.F.R. 251.203. In light of these regulatory requirements I would appreciate your amplifying your testimony to explain further your observation made at the hearing.

Again, I appreciate the time and effort you have expended in addressing the Subcommittee's earlier questions and appreciate your contributions to the Subcommittee's deliberations.

Sincerely,

Bob Graham

Bob Graham
HUD/Mod Rehab
Investigations Subcommittee

1125 Fifteenth Street, N.W.
Washington, D.C. 20005
202-861-6500

Mortgage Bankers Association of America

May 7, 1990

The Honorable Bob Graham
HUD/Mod Rehab
Investigation Subcommittee
Senate Committee on Banking, Housing
and Urban Affairs
Washington, DC 20510

Dear Mr. Chairman:

We are pleased to respond to your letter of April 12, 1990, and your request to supplement our explanation of the alternative methods of calculating maximum mortgage amounts under the coinsurance programs.

In the Section 223(f) program for acquisition and refinancing of low and moderate income rental units and the Section 221(d) program for new construction, the maximum mortgage amount for a specific project is determined by several calculations.

For 223(f), the mortgage amount is the lesser of:

(a) the amount calculated by using the per unit statutory limits;
(b) 85% of appraised value;
(c) for acquisitions: 85% of cost, including purchase price, financing fees, renovation costs, and other transactional costs;
for refinance transactions: the greater of 100% of costs, (including existing debt, finance fees, renovation costs, and other transactional costs), or 70% of appraised value; or
(d) the mortgage which can be supported using 85% of projected net operating income (NOI) for debt service.

For 221(d) projects, the mortgage amount is the lower of:

(a) the amount calculated by using the per unit statutory limits;
(b) 90% of certified cost (100% for nonprofit owners); or
(c) the mortgage which can be supported using 90% of NOI for debt service (95% for nonprofit owners).

Although the last constraint on the mortgage amount (utilizing debt service coverage) for both programs should have effectively limited the mortgage at something close to 85% or 90% of its appraised value, the rules for trending rents, particularly for properties which were being constructed or undergoing renovation, were sufficiently subjective to allow very aggressive calculations of project NOI.

Under the Fannie Mae program, in contrast, rent trending is allowed only in certain specified circumstances and only as leases turn over on existing projects. In addition, the loan amount must be backed up by an appraisal which is carefully reviewed by Fannie Mae for irregularities. Many people in our industry believe that a tighter approach to defining appraised value and the mortgage amount as a percentage of appraised value would benefit the HUD programs.

We are happy to respond to any further questions you may have at a future date.

Sincerely,

Gaye G Beasley/cjp

Warren Lasko
Executive Vice President
Mortgage Bankers Association

Gaye Beasley
President
Patrician Mortgage

CHART A

Defaulted Coinsured Loans

Since Moratorium Began in May 1989

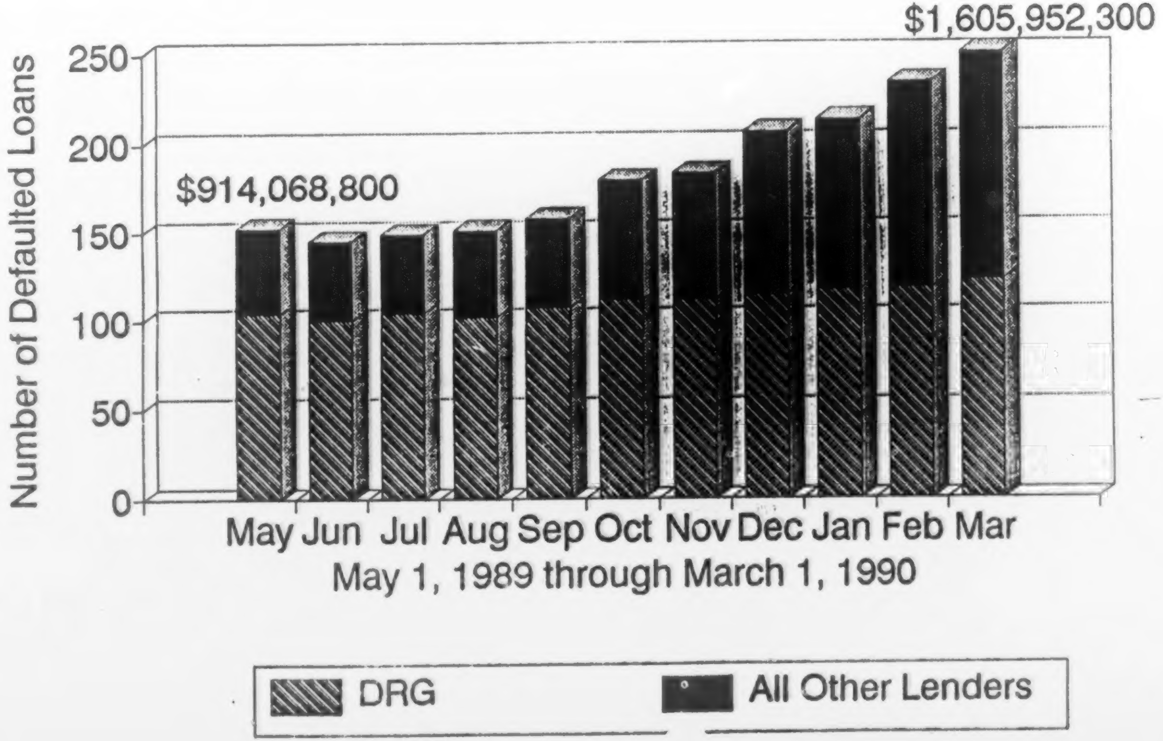


CHART B

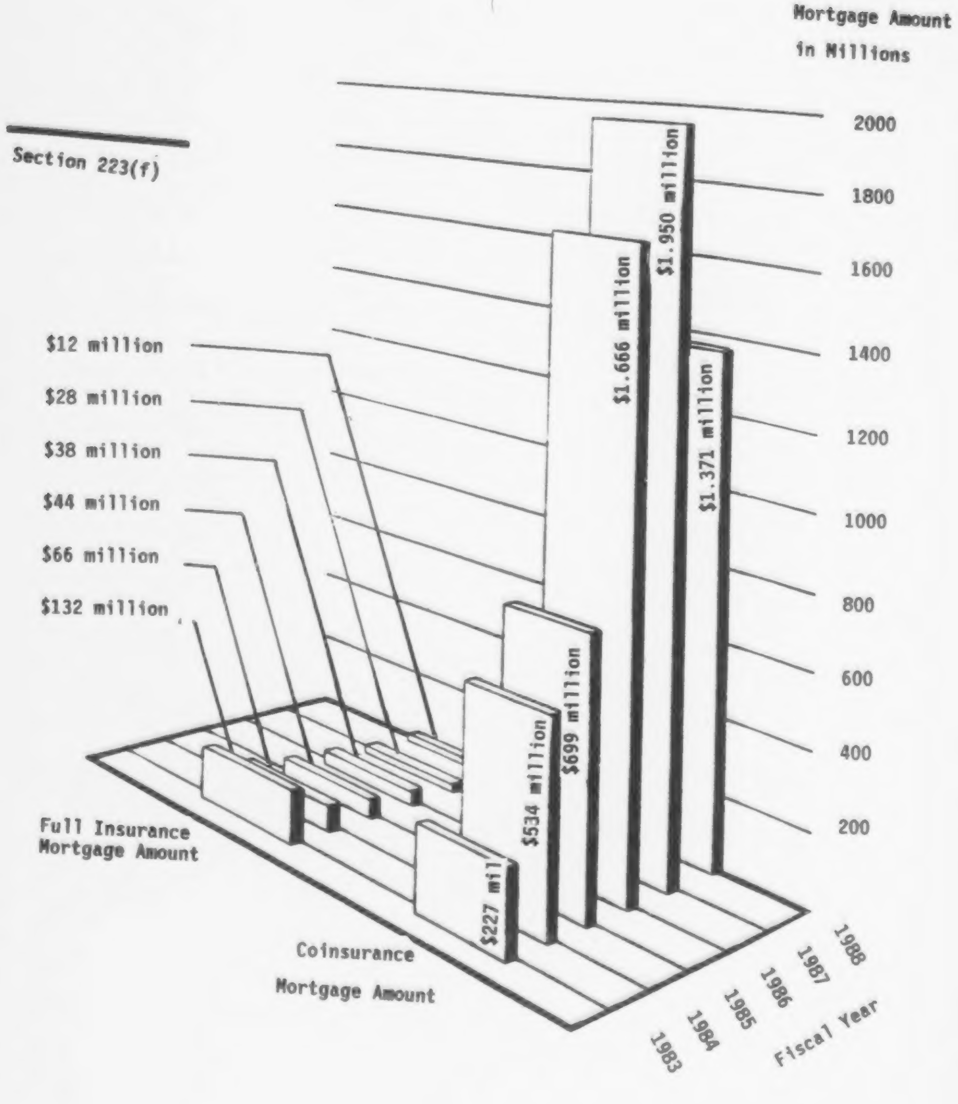

Mortgage Amount in Millions
Section 223(f)
2000
1800
1600
1400
1200
1000
800
600
400
200
$12 million
$28 million
$38 million
$44 million
$66 million
$132 million
$1.950 million
$1.666 million
$1.371 million
$699 million
$534 million
$227 mil
Full Insurance Mortgage Amount
Coinsurance Mortgage Amount
1983
1984
1985
1986
1987
1988
Fiscal Year

CHART C

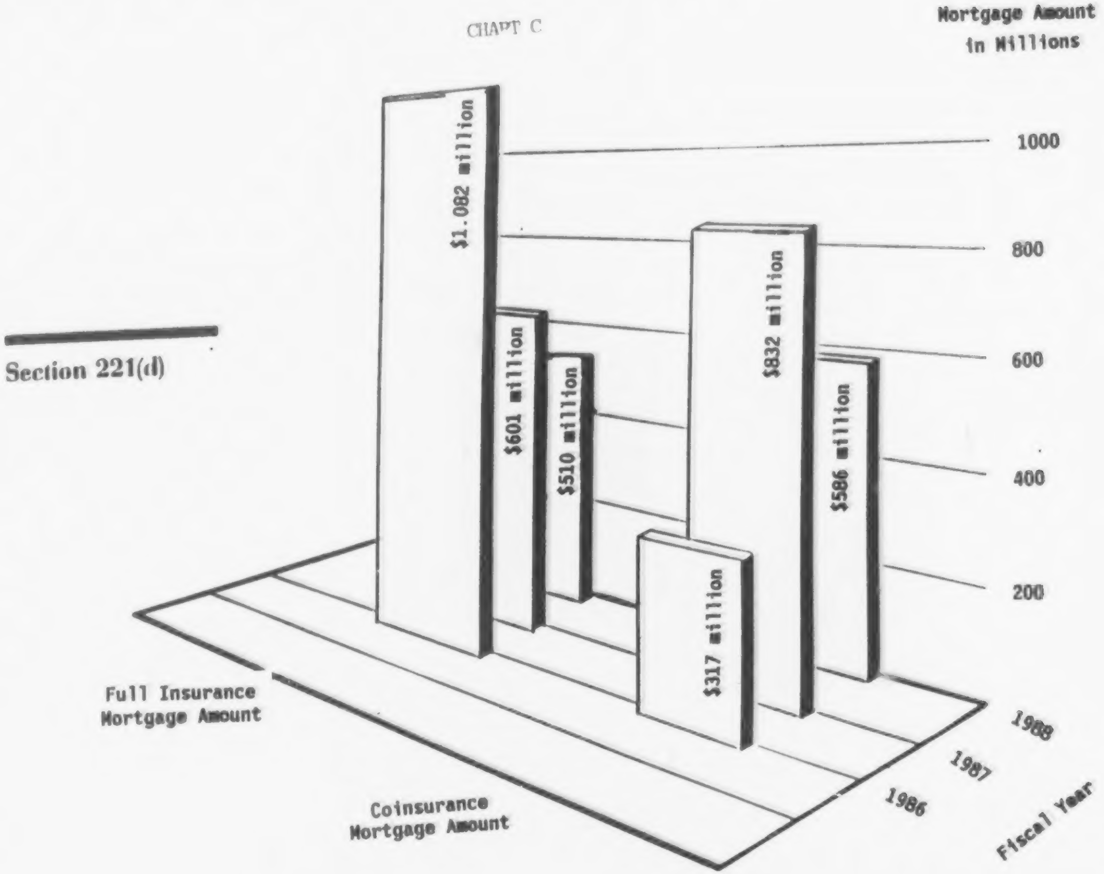

Section 221(d)
Mortgage Amount in Millions
1000
800
600
400
200
$1.082 million
$601 million
$510 million
$832 million
$586 million
$317 million
Full Insurance Mortgage Amount
Coinsurance Mortgage Amount
1988
1987
1986
Fiscal Year

CHART D

ILLUSTRATION OF HOW FHA'S MULTIFAMILY COINSURANCE AND GNMA'S MBS PROGRAMS WORK TOGETHER

Sequence of Events Involved in Creation of Coinsured Loan and Issuance of GMNA Securities

(1) The lender purchases a guarantee commitment from GNMA and GNMA issues that commitment.

(2) A "warehouse" bank provides the lender a "bridge" or "warehouse" loan.

(3) The lender uses funds from the warehouse loan to make the mortgage loan, which FHA coinsures.

(4) The lender issues GNMA securities to a securities dealer (broker), who, in turn, markets the securities to an investor.

(5) The investor purchases the securities from the broker, who, in turn, pays the lender.

(6) The lender uses the proceeds from the sale of the securities to pay off the warehouse loan, thus completing the transaction.

CHART E

COMPLIANCE WITH COINSURANCE PROGRAM REQUIREMENTS

HUD On-Site Monitoring

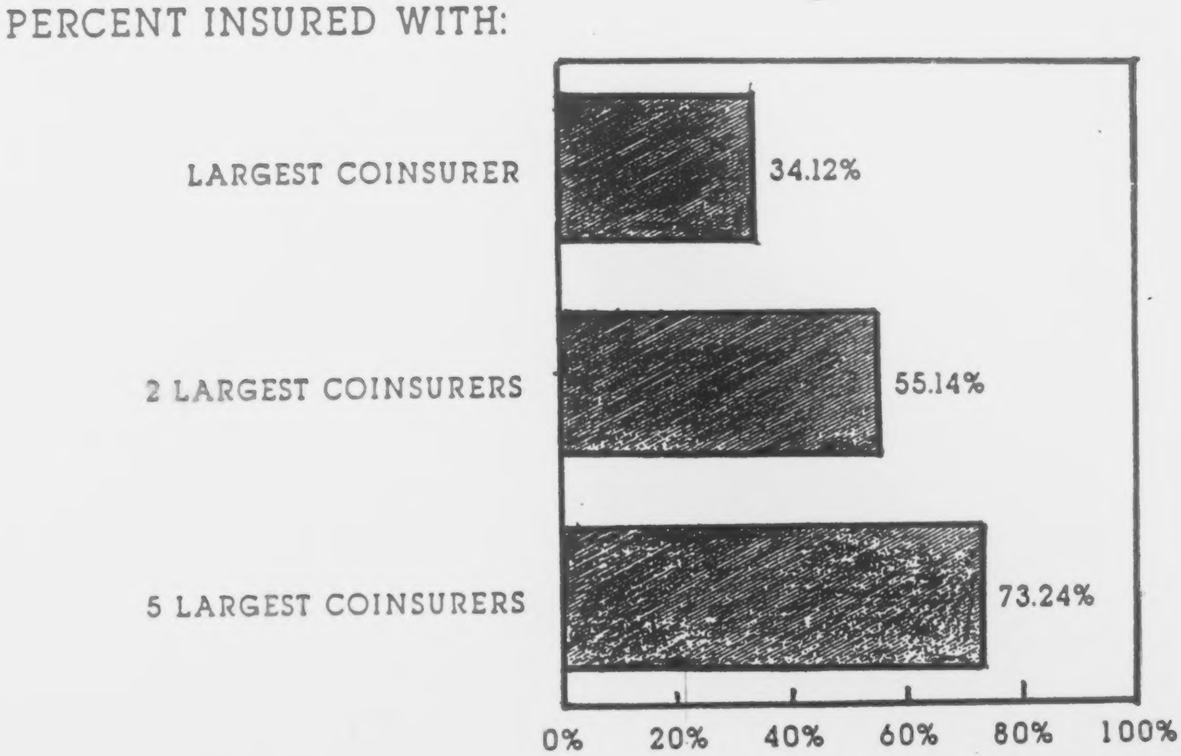
Fiscal Year	No. of HUD On-Site Reviews
1985	0
1986	2
1987	6
1988	7

TABLE 2 : COINSURANCE DEFAULTS AND CLAIMS AS OF AUGUST 31, 1989

	DEFAULTS			CLAIMS PAID	
	PROJECTS	MORTGAGE AMT.	%*	PROJECTS	AMOUNT PAID
Sec. 223 (f)	140	$800,863,000	13.2	23	$66,895,766
Sec. 221 (d)	11	117,612,800	5.1	0	0
Sec. 232	0	0	0.0	0	0
	151	$917,475,800	11.0	23	$66,895,766

*Percentage of coinsurance in force.

CONCENTRATION OF RISK AMONG THE LARGEST COINSURERS



PAST AND PRESENT HUD MANAGEMENT: MATERIAL WEAKNESSES

WEDNESDAY, APRIL 18, 1990

United States Senate,
Committee on Banking, Housing, and Urban Affairs,
HUD/Mod Rehab Investigation Subcommittee,
Washington, DC.

The subcommittee met at 2:05 p.m., in room SD-538 of the Dirksen Senate Office Building, Senator Graham (chairman of the Subcommittee on HUD/Mod Rehab Investigations) presiding.

Present: Senators Graham and Mack.

OPENING STATEMENT OF SENATOR GRAHAM

Senator Graham. I call the meeting to order. The National Commission on the Public Service, known as the Volcker Commission, recognized last year that it is primarily the responsibility of agency managers to achieve excellence in Government programs.

The commission said that only by striving for such excellence can we restore the American citizens' shaken faith in public service.

Today, our subcommittee will look at past and present efforts of HUD management to provide excellence in its programs. As we enter this area, we should remember the interesting pattern found by the Volcker Commission during the course of its work.

The commission found that, in surveying the public's perception of Government, we see a pattern of increased confidence in Government during the start of a new presidential administration, followed by a gradual reduction in confidence over time.

We saw this pattern in the attitudes of HUD's top management during the 1980's, a burst of interest by the Pierce administration during its early stages, followed by a gradual diminution of interest.

Toward the end of the Pierce era, we discovered a period of self-deception in HUD management's efforts to assess its problems. We now have a new administration at HUD and the interest in effective management has increased again. And confidence in this new administration is high.

However we want to see this interest grow and not fade away during the course of Secretary Kemp's tenure at HUD.

Today's look at HUD's management will involve examination of HUD's compliance with the Federal Managers Financial Integrity Act, referred to as FMFIA. According to FMFIA, HUD must perform the following duties:

First, HUD must perform comprehensive evaluations of internal controls and accounting systems.

The second requirement, under the Federal Managers Financial Integrity Act, is that HUD managers must report annually to the President and Congress material weaknesses within these internal controls and accounting systems.

Third, HUD managers must include in each annual report plans for correcting each identified material weakness.

This subcommittee found troubling the reporting efforts of the HUD during the Pierce administration. I will provide some examples:

In 1987, HUD certified in its FMFIA report that HUD accounting systems were fine. This clean bill of health specifically included HUD's accounting controls for FHA funds. However, HUD management had on hand at the same time a report issued by an independent accounting firm that listed numerous problems with HUD's accounting systems, including the fact that HUD's accounting for the FHA fund did not conform to generally accepted accounting standards.

Later, a GAO and Price-Waterhouse audit confirmed problems with HUD's accounting of the FHA fund, noting that HUD was underestimating losses by as much as 80 percent.

Another example. In 1983, HUD said in its FMFIA report that there existed a material weakness with its review of single family home appraisals. In 1985, HUD reported that this weakness had been corrected. In fact, the weakness had not been corrected and HUD recently reported in its 1989 report that it is still experiencing serious problems in controlling faulty appraisals relating to single family loans.

Also, in 1987, HUD identified problems that later allowed "Robin HUD" to embezzle millions of dollars from the agency, but HUD officials failed to correct these problems.

Today, we have three panels of witnesses who have direct knowledge of the process as conducted by the Pierce and Kemp administrations.

The first group include Inspector General Adams and members of his office, which is responsible for monitoring HUD management efforts to compile FMFIA reports.

The second panel, consisting of Under Secretary DelliBovi and two representatives of HUD's Office of administration, actually put together these reports.

The third panel consists of Assistant Comptroller Chapin and two accompaning GAO representatives. GAO has conducted four studies on the implementation of the FMFIA process throughout the Government.

We appreciate all of your willingness to participate with us today. We will now hear from the first panel, Inspector General Paul Adams; Mr. Chris Greer, Assistant Inspector General for Audit; and Mr. James Martin, Director of Planning and Administration in the Office of Audit.

I would like at this time to call upon the ranking member of the committee for any opening comments, Senator Mack.

Senator MACK. Thank you, Senator Graham.

STATEMENT OF SENATOR CONNIE MACK

I would like to thank today's witnesses for their presence today as we examine HUD's compliance with the Federal Managers Financial Integrity Act (FMFIA) ("FIM-FEE-A").

The Federal Managers Integrity Act requires the U.S. Department of Housing and Urban Development (HUD) and other agencies to perform comprehensive internal evaluations of agency internal controls and accounting systems.

It appears to be the consensus there were compliance problems in the past at HUD with regard to FMFIA. From only a brief glance at the past and current administrations' reports on internal controls and financial systems, one can conclude the Kemp team has taken the initiative to dramatically improve HUD's track record on self-evaluation.

I look forward to hearing today's testimony especially as it relates to the substantive changes HUD has made to improve its internal controls. I commend Secretary Kemp for moving ahead so quickly and forthrightly in correcting past failures. I urge him and the entire management team at HUD to continue this postive momentum in setting a model precedent for future administrations.

Let me say this. It's obvious from reading the materials that were prepared for us, looking through the 1989 report and HUD's reaction to that, that there is a higher degree of concern and awareness of responsibilities which I take as a very positive step.

I think the key, frankly, is to determine over a period of time how the suggestions that were made in response to these various reports, how they're going to be carried out and, in fact, whether they're put in place.

So I look forward to your testimony and look forward to the opportunity to carrying on a discussion about changes that have been made, and maybe some other suggestions that you might have.

Thank you.

Senator GRAHAM. As has been our general practice when we have hearings of this nature before the subcommittee, we will swear each panel. It's my understanding that panel number two has not arrived at this time.

So, if those participants in panel No. 1 would please stand.

[Panelists sworn.]

Senator GRAHAM. Thank you, gentlemen.

Mr. Adams.

TESTIMONY OF PAUL ADAMS, INSPECTOR GENERAL, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, WASHINGTON, DC, ACCOMPANIED BY CHRIS GREER, ASSISTANT INSPECTOR GENERAL FOR AUDIT, HUD; AND JAMES MARTIN, DIRECTOR OF PLANNING AND ADMINISTRATION, OFFICE OF AUDIT, HUD

Mr. ADAMS. Thank you, Mr. Chairman. With your permission, I'll submit my statement for the record and briefly summarize.

We all share your concern about effective implementation of the Federal Managers Financial Integrity Act. We would like to share our brief thoughts with you.

Our office has had a longstanding role in the implementation of internal controls at the Department. As far back as 1979, we developed two processes which we recommend that the Department implement, and chose to do those.

However, they only enjoyed limited success because, in our opinion, there was not a full commitment on the part of the management to support those systems.

As the act was implemented, we played three roles in the process: (1) was technical assistance to the departmental management to implement the act, (2) annual audit of the program, and (3) general coverage and reporting on internal controls as we did our audit work in various HUD programs.

From the period 1983 through 1988, we issued seven reports on HUD's FMFIA process. Our reports showed that probably more was expended on the defining and refining the process than was expended on actually evaluating and improving the HUD controls and the systems of the Department.

The majority of the material weaknesses reported during those periods were identified by our audit staff, and the bulk of the remainder were identified by contract personnel rather than by departmental managers themselves.

In 1987, there were substantial disagreements between us and some of the assistant secretaries, as to the material weaknesses we had identified. Prior to that time, we had dealt with their respective staffs as we started developing the report at the end of the year, and usually we were able to reach a consensus on the material weaknesses.

However, in 1987 that did not occur. We had substantial discussions and, ultimately, 9 out of the 11 material weaknesses we challenged were included in the Department's report.

Those disagreements continued and became a little more exacerbated in 1988. At that time we had been through the same process working with the staff and achieved agreement on the bulk of the disagreed weaknesses (16 of 21). There were still 5 out of the 21 in dispute. This however, resulted in a direct confrontation between myself and the various assistant secretaries.

And only through our insistence were four of those five material weaknesses included in the 1988 report.

You might be interested to know that two of the disputed areas in 1988 included the section 8 Mod Rehab Program and the Coinsurance Program.

As a result of those disagreements, in January 1989, I made a policy decision that each issued audit would include an affirmative statement if we thought the program had a material weakness. That was done to reinforce HUD's FMFIA system.

Senator MACK. Excuse me? Could I get you to say that again?

Mr. ADAMS. In 1989, we chose as a policy that, if we believed there was a material weakness in the program, we would so declare in the audit report as we issued the report. We had not done that prior to that time. We thought this method brought the issue to the forefront at a much earlier stage of the process, so, management could start coping with the issue, and so we could eliminate or minimize any subsequent disputes.

We have not experienced any disputes this year.

In summary, I believe that the top management of the prior administration did not embrace the concept or support the act's implementation. In lieu of complying with the act, they focused more on reducing the size of HUD and giving the appearance that they were doing more with less.

Therefore, HUD derived few actual benefits in terms of substantive evaluations or improvements to HUD's internal controls.

I know my testimony until this time has been rather negative in tone. However, I would like to deal more directly with the current situation and my personal view is that Secretary Kemp and his team have restructured the internal control process at the Department to address all our priority concerns.

More significant, than the Kemp administration's future plans to comply with the act is the strong management support being given to correcting the deficient conditions.

In conclusion, I would only state that, like you, I have some their concerns about the continuation of this current interest and enthusiasm. Probably more oversight needs to be done by the Office of Management and Budget and the Congress itself. Continued interest on your part will ensure the effective implementation of those corrections.

Thank you. That concludes my remarks. I'll be pleased to respond to any questions you may have.

[The complete prepared statement of Paul B. Adams follows:]

Statement of

Paul A. Adams, Inspector General

Department of Housing and Urban Development

Accompanied by Chris Greer, Assistant Inspector General for Audit and

Jim Martin, Director, Planning and Administration

Before the Committee on Banking, Housing and

Urban Affairs

United States Senate

April 18, 1990

Mr. Chairman and Members of the Committee, I appreciate the opportunity to discuss our Office's efforts to improve the Department of Housing and Urban Development's (HUD) implementation of the Federal Managers' Financial Integrity Act of 1982 (Act). Accompanying me today are Chris Greer, Assistant Inspector General for Audit, and James Martin, Director of Audit Planning and Administration.

The Act provides clearly that is a "management responsibility" to establish internal control and financial management systems, so that Federal agencies can provide reasonable assurance that:

--Obligations and costs comply with applicable laws;

--Assets are safeguarded against waste, loss, unauthorized use, or misappropriations; and

--Operating revenues and expenditures are properly recorded and accounted for so that reliable financial and statistical reports can maintain accountability over the assets.

The Office of Inspector General (OIG) plays a critical role in the FMFIA process however, the OIG's role can vary widely, depending on management's attitude and approach.

Even before the Act was passed our office was very active in providing technical assistance to HUD management on internal control matters.

For example:

- In 1979, a Fraud Vulnerability Assessment System was started through HUD's Committee on Fraud, Waste and Mismanagement (CFWM), which I chaired. This system required program managers to evaluate the risks and controls to be implemented in new or substantially revised HUD programs and operations;

- The following year, our office developed and HUD implemented the Management Control Assessment System (MCAS) requiring managers to evaluate controls over existing programs and operations, on a cyclical basis.

These systems enjoyed limited success at HUD because in our opinion top management did not fully support the systems. Nonetheless, GAO used the methods developed at HUD in preparing its guidance for implementing the Federal Managers' Financial Integrity Act of 1982 (FMFIA).

When the Act became effective, the Secretary assigned the Assistant Secretary for Administration the responsibility for implementing the Act. This responsibility also included implementing OMB Circulars A-123 (Internal Controls) and A-127 (Financial Management Systems). As the Departmental Internal Control Coordinator (DICC), the Assistant Secretary for Administration assigned a small staff to provide guidance and to coordinate activities with HUD's Assistant Secretaries.

Our office participated in the Act's implementation in three ways. We provided:

- Technical assistance to HUD management,
- Annual audits of the program, and
- General coverage and reporting on the adequacy of internal controls during our audit work on HUD programs.

From 1983 - 1988, our office audited HUD's compliance with the Act annually. (Summaries of the six issued reports are attached to this statement.) In general, our audits show that more effort was expended on defining and refining the program process than was expended in actually evaluating and improving HUD's controls and systems. Although management reportedly agreed with many of our recommendations, improvements were not supported by top management and/or were not implemented effectively. As a result, the program basically was a paper exercise that contributed little in the way of evaluating and improving HUD's internal control and financial management systems.

Internal Management Controls

In the early years (1983-1985), HUD's managers were not held accountable for planning and completing any cyclical evaluations of the internal controls in their respective areas. However, in 1986 the revised OMB Circular A-123 required managers to establish and adhere to Management Control Plans which scheduled internal control evaluations on a 5-year cycle. Although HUD managers prepared the required plans. They did not perform the evaluations.

Annual Assurance Statements from each Assistant Secretary were required to identify problems. However, few new weaknesses were reported by HUD officials in their annual statements. Because management did not evaluate their controls and systems, the majority of the 93 material internal control weaknesses reported by HUD over the last 7 years came from OIG work. Furthermore, the few weaknesses that were identified came from the GAO or through contracted internal control reviews not from manager evaluations. Many of the material weakness areas we identified were included in HUD's annual FMFIA reports over the objections of the responsible Assistant Secretary. Disagreements on material weakness issues in the mid-80s caused our role to shift from that of an advisor; to that of an adversary.

From 1983-1986, material weaknesses identified by OIG would be informally discussed and agreed to in year-end meetings between various representatives of program offices and our staff. However, in 1987, several Assistant Secretaries disagreed with the material weakness areas we identified and an informal agreement could not be reached. Therefore, our audit report specifically recommended that the Department report 11 new material weakness areas not agreed to by the Assistant Secretaries. These areas included:

1. CPD Section 312 Loan Servicing
2. CPD Technical Assistance Program
3. Distributive Shares/One Time Mortgage Insurance Refund Payment Process
4. One Time Mortgage Insurance Premium Collection Process
5. Single Family Mortgage Insurance Origination
6. Single Family Property Disposition
7. Section 8 Special Claims
8. Section 8 Existing Housing Program
9. Multifamily Insured Loan or HUD-Held Servicing
10. Coinsurance Program
11. Tenant Income Verification

Ultimately, 9 of these weaknesses were included in the Secretary's Annual Statement. Although 9 of these weaknesses were reported, management's commitment to correcting them was in question.

Further disagreements between Assistant Secretaries and the OIG in 1988 caused us to recommend that the Secretary's Annual Statement provide a detailed list of material weaknesses disclosed by our audit work that were not identified by the responsible Assistant Secretary. This approach would make users of HUD's Statement aware of the disagreements. Some of the disputed areas were the Section 8 Moderate Rehabilitation Program and the Coinsurance Program. Again these weaknesses were ultimately reported in HUD's Annual Statement, but not without much heated discussion and insistence by our office.

In January 1989, our office established a policy of specifically identifying material weaknesses in our audit reports. In addition, we provide to the Control Coordinator lists of all the audit reports identifying material weaknesses. We adopted these procedures because of past management's reluctance to properly consider and act upon significant OIG audit work.

Financial Management Systems

In addition to the internal management controls we just discussed, the Act also contains specific requirements for financial management systems. Prior to 1986, HUD did very little to evaluate its financial management systems. In 1986, HUD attempted to address this issue through a questionnaire approach. Managers were asked to answer questions that were structured in such a way that a "yes" response meant that the systems were judged to comply with OMB requirements while a "no" response indicated possible noncompliance. As part of our 1986 audit we reviewed HUD's analysis of the questionnaire responses. We noted that little analysis work was performed on the questionnaires. Nonetheless, the staff responsible for preparing the Annual Statement proposed that the questionnaire responses be used as a basis for reporting that HUD's financial management systems complied with A-127. In fact, our review showed that many respondents to the questionnaire pointed out serious problems. After our audit report was issued, HUD management revised the Annual Statement to say that HUD had no firm basis to report on its compliance with the Act's requirements.

In preparing its 1987 Annual Statement regarding financial management systems, HUD management relied on work performed by contractors ($1.5 million over a 12-month period). During our 1988 audit, we reviewed the 1987 contractor performance and noted that the 1987 Annual Statement was deficient for two reasons: First, the contract did not cover some critical internal control aspects of HUD's financial systems. Second, even though the contractors' work disclosed some significant noncompliance issues, HUD did not report these items. Rather HUD drew attention away from actual deficiencies by saying, "opportunities for strengthening operating efficiency and effectiveness exist."

Summary

In summary, we believe that top management in the prior administration neither embraced the concept, nor supported the Act's implementation. In lieu of complying with the Act, they focused on reducing HUD's size and giving the "appearance" that they were "doing more with less." Therefore, HUD derived few actual benefits in terms of substantive evaluation and improvement of HUD's internal controls and financial management systems. I believe this inaction increased HUD's vulnerability to fraud, waste and mismanagement.

Mr. Chairman, despite the negative tone of this statement, we believe the future will be better. Secretary Kemp and his team have restructured HUD's internal control program to address our prior audit concerns.

However, even more significant than the Kemp administration's future plans to comply with the Act, is the strong top management support being given to correcting the past management weaknesses. Through the effort of 26 Program Financial Management Task Forces established by the Secretary, specific actions and resources needed to correct the weaknesses have been outlined and are being tracked and monitored closely.

Under Secretary Kemp, our relationship with top management has improved. I meet weekly with the Under Secretary and his staff; the Assistant IG for Audit meets frequently with the Program Assistant Secretaries to exchange information and ideas. Secretary Kemp holds his Principal staff accountable for establishing sound management systems as the Act intended.

We are encouraged by the positive management attitude of the Kemp administration. However, we also believe that Congress and OMB can and should play a stronger role in this process by closely monitoring HUD, and other Federal agencies, to assure that management controls are working and that program operations are conducted effectively and efficiently.

This concludes my remarks. Thank you for your attention.

1983

SUMMARY OF RESULTS

HUD's evaluation of its system of internal control was being conducted in a reasonable and prudent manner. HUD has been recognized by OMB as a leader among the Federal Agencies in implementing Congressional and Executive mandates for reviews of and improvements to systems of internal control in the Federal Government. However, the process of evaluating systems of internal control is lengthy and ongoing, and there is still much to be done at HUD.

In our opinion, HUD's evaluation of its systems of internal control did not progress to the point where the full assurances required by A-123/FMFIA can be provided in the first annual statement due from the Secretary by December 31, 1983. This was because HUD's internal control evaluation process was not implemented in their Field Offices until late September 1983 and phases of the overall evaluation process need to be further developed.

HUD's progress in implementing their internal control evaluation process was hindered by: (1) changing and evolving OMB and GAO guidance, (2) reorganization in the Field Office structure, and (3) resource constraints on administering the process and performing internal control reviews on headquarter's activities.

Our review indicates that HUD's progress through September 30, 1983 included:

--Organizing the process in a manner which complied with OMB's guidelines.

--Segmenting the agency into 391 assessable units including most major programs and functions.

--Completing 391 vulnerability assessments (VAs) on Headquarters' programs and functions and initiating 1,270 supplemental vulnerability assessments on programs and functions applicable to the 10 Regional Offices.

--Establishing a preliminary review (PR) process to determine the causes of and solutions for problems readily identifiable from VAs.

--Completing PRs on all 65 highly ranked, and some moderately ranked, Headquarters VAs resulting in the identification of 145 problems and 248 corrective actions.

--Completing 16 of 33 internal control reviews (ICRs) scheduled in the Office of Finance and Accounting.

--Scheduling 5 ICRs in other areas of HUD which were in process.

--Developing and implementing a tracking/follow-up system to assure timely management action on the results of VAs, PRs and ICRs.

HUD needs to complete the following tasks in Fiscal Year 1984 to enable the Department to provide the assurances required by A-123/FMFIA:

--Complete the VAs initiated in the Regional Offices, integrate the results into Headquarters VAs and make appropriate adjustments to the final ratings and rankings within each organizational segment.

--Extend the PR process to the Regional Offices.

--Complete PRs on moderately ranked Headquarters VAs.

--Select, schedule and complete ICRs in each of the respective organizational segments based on the revised VA rankings and PR results.

--Continue to track and follow-up on corrective actions indicated in the VA, PR and ICR phases to assure that timely actions are taken.

--Complete and issue the HUD Internal Control Handbook to standardize the process.

On the basis of our review, we further recommend that the Assistant Secretary for Administration, as the designated responsible official:

--Establish documentation standards for future use on each phase of HUD's internal control evaluation process.

--Establish criteria and procedures for performing quality assessments of completed VAs, PRs and ICRs and apply them to assure the quality of work performed.

--Assess the workload related to the central coordination function in the next year and assign resources as appropriate.

--Develop and implement a process to periodically update the inventory of assessable units to reflect changes in operations, program responsibility and organizational structures. The first update should include omissions from the original inventory of assessable units.

--Standardize HUD's ICR guidance to assure consistency with the intent of OMB's guidelines.

--Develop and implement a system to verify that adequate and timely corrective actions on system weaknesses are taken as reported.

--Establish sufficient methodologies and quality control for the PR process to assure that management has properly identified those areas that require more indepth ICRs.

Our report was discussed with the Departmental Coordinator's staff who generally agreed with Fiscal Year 1984 actions and our recommendations.

1984

SUMMARY OF RESULTS

Although progress was made, HUD fell short of what was planned in last year's annual statement to the President and the Congress (Attachment I). Therefore, HUD failed to complete the full process. We also believe that the quality of the vulnerability assessment and preliminary review phases of HUD's internal control evaluation process must be improved.

Since HUD's internal control evaluation process is still incomplete, we believe the Secretary cannot provide the President and Congress with the assurances as required by OMB Circular No. A-123 and the Federal Managers' Financial Integrity Act of 1982, that reasonable controls are in place and operating. Furthermore, our concern with timely and adequate implementation of the internal control evaluation process is heightened because preliminary reviews performed by the Regional Offices are indicating significant internal control problems, including lack of sufficient and qualified staff and inadequate procedures, which have yet to be addressed. The internal control evaluation process must be completed to totally assess the validity of these and other potential weaknesses.

HUD's progress in FY 1984 included:

- Completing 1,214 vulnerability assessments on Regional Offices' programs and functions.
- Completing preliminary reviews on 3 highly ranked and 46 moderately ranked vulnerability assessments in Headquarters.
- Initiating preliminary reviews in Regional Offices on 115 assessable units.
- Completing 14 internal control reviews in the Office of Finance and Accounting (OFA).
- Completing 4 internal control reviews in other areas of HUD which were in process at the beginning of the year.
- Scheduling 6 internal control reviews in OFA and the Office of Public and Indian Housing for Fiscal Year 1985.
- Developing a tracking and follow-up system to assure timely management action on the results of vulnerability assessments, preliminary reviews and internal control reviews for the Regional Offices.
- Initiating the evaluation process for all major automated data processing (ADP) applications.
- Reviewing for quality preliminary reviews conducted in FY 1983 in Headquarters on highly rated assessable units and bringing to the attention of the respective Assistant Secretaries major program areas requiring internal control reviews.

In our opinion, HUD must complete, at a minimum, the following aspects of its internal control evaluation process before assurances can be provided as required:

- Complete the internal control evaluation process on all highly and moderately vulnerable ADP systems;
- Complete preliminary reviews on all highly and moderately ranked assessable units in Regional Offices and compare the results with the results of the preliminary reviews performed in Headquarters so that all known problem areas are identified and addressed;
- Select, schedule and complete internal control reviews in each of the respective organizational segments where preliminary review results recommended such; and
- Continue to track and begin to verify that corrective actions identified by the internal control system evaluation process are implemented as scheduled, especially those pertaining to "material weaknesses."

We were advised that HUD's lack of progress in implementing its evaluation process was due to: (1) resource constraints available to carry out the process, (2) reorganization in the Field Office structure; and (3) lack of expertise and knowledge with the process. In our opinion, the Department must make every effort to complete the evaluation process in FY 1985.

On the basis of our review, we are recommending that you, as the designated responsible official, complete the following actions by February 19, 1985, to strengthen HUD's internal control process:

- Expedite the issuance and implementation of quality control procedures.
- Institute a quality assessment of completed low-rated vulnerability assessments performed in the Regional Offices and have those that do not meet quality standards returned to the Regional Offices for correction and possible re-rating.
- Reassess the method and content of training courses for future vulnerability assessment preparers to determine who should train the preparers and what the appropriate coverage should be.
- Increase the number of preliminary reviews being conducted by the Regional Offices so that the internal control evaluation process is expedited within the Department. In the event it is determined that all Regional Offices' preliminary reviews cannot be conducted in FY 1985, preliminary reviews must be targeted towards the highly vulnerable areas.

- Combine the vulnerability assessment and preliminary review process into one phase in order to assure that continuity is maintained.
- Require (a) the use of preliminary review predesigned working papers, (b) the use of cost benefit data on all preliminary reviews, and (c) that preliminary reviews be adequately documented.
- Revise guidance for future year-end FMFIA reporting by including examples of reporting other than reasonable assurances.
- Review all FY 1984 assurance letters and ascertain that the assurance letters' conclusions reflect the actual conditions in existence at the end of the fiscal year.
- Ascertain whether all appropriate Senior Executive Service (SES) and Merit Pay Managers have performance standards which reflect internal control responsibilities and ensure that all managers are knowledgeable of how they are expected to carry out their internal control responsibilities.

Our results were discussed with the Departmental Coordinator's staff, who generally agreed with our findings and recommendations. They advised us that documentation and quality control would be emphasized in FY 1985.

SUMMARY

The Department made limited progress in evaluating its systems of internal control. In our opinion, the limited progress was due to an absence of commitment to the evaluation process, insufficient staff assigned to the task and an absence of a comprehensive plan that would assure completing the evaluation process in a reasonable period of time. Consequently, the Secretary still does not have a satisfactory basis to form an overall conclusion about the adequacy of HUD's systems of internal control. We believe the Secretary will have to provide, for the third consecutive year, a qualified statement to the President and Congress on the adequacy of HUD's systems of internal control because the evaluation process was not completed.

Departmental officials recognized that their current evaluation approach needed revision and started to revise their strategy for performing evaluations in late Fiscal Year (FY) 1985. As of September 30, 1985, the revised strategy was not completely developed. We are recommending that the Assistant Secretary for Administration complete the development of the revised strategy as quickly as possible and establish a comprehensive implementation plan with milestones which would place the Secretary in a position to provide a complete statement on the adequacy of HUD's systems of internal control. We are also recommending that the Assistant Secretary make the commitment to provide the level of effort necessary to implement the plan and develop a system of accountability to assure that the evaluation process is completed within the established milestones.

The Department did not fully comply with OMB Circular No. A-127, Financial Management Systems, or OMB Bulletin No. 85-15, Financial Management Improvement Projects. We were advised that this was due to disagreement by the Assistant Secretary for Administration with some of its requirements. Without compliance, we believe that the Secretary cannot provide full assurance to the President in the 1985 FMFIA report that the Department's accounting systems conform to the principles, standards and related requirements prescribed by the Comptroller General, as implemented through OMB Circular No. A-127.

We discussed our results with the Assistant Secretary for Administration's staff who generally agreed with the recommendations.

The finding included in this report is the conclusion of the HUD Office of Inspector General, based on the auditor's testing of operations. The finding is subject to review and determination by your office, as to corrective actions needed in accordance with procedures in HUD Handbook 2000.6 REV, Audits Management System.

1986

EXECUTIVE SUMMARY

The audit was conducted to determine whether: the evaluation of internal controls was in accordance with OMB Circular A-123; changes to the evaluation process were consistent with Circular A-123 revisions; and evaluations of the financial management systems were in accordance with Circular A-127. The Circulars which implement the Federal Manager's Financial Integrity Act of 1982 (FMFIA), require an annual statement from the Secretary to the President and the Congress on the results of the agency's evaluations of its internal controls and financial management systems.

In our opinion, the Secretary can provide reasonable assurance of A-123 compliance to the President and Congress on those areas evaluated to date. The Fiscal Year 1986 internal control reviews were generally in accordance with OMB guidelines and corrective actions for 2 previously reported material weaknesses were adequately implemented. However, internal control reviews were not conducted in the Department's most vulnerable areas and corrective actions relating to 4 additional material weaknesses could be more accurately reported.

Changes to the Department's evaluation process were generally in accordance with OMB's revisions to Circular A-123. However, HUD had not: (1) scheduled evaluations of all its highly vulnerable areas during FY 1987 as required by the revision; (2) reconciled the effects of the recent consolidation of the original 422 assessable units to the new universe of 81 assessable units; and (3) fully incorporated alternate internal control reviews into the process. We recommend actions to improve compliance with Circular A-123.

The principal effort carried out by HUD to evaluate its FMA systems in accordance with OMB Circular A-127 was a survey questionnaire developed from OMB's Guidelines for Evaluating Financial Management/Accounting Systems. The results of the questionnaire were given to a contractor who will perform a detailed evaluation of HUD's FMA systems in FY 1987. Until this detailed review is complete, a sufficient basis does not exist to conclude HUD's FMA systems conform with GAO accounting principles and standards.

We recommend that the Assistant Secretary for Administration advise the Secretary that HUD cannot report that its FMA systems are in compliance with requirements implemented through Circular No. A-127. Two additional recommendations were provided to ensure HUD's full compliance with A-127 requirements.

The Office of Administration has advised us that it agrees with our findings and recommendations.

1987

EXECUTIVE SUMMARY

We audited HUD's process for evaluating its systems of internal control (the process), which is required by Office of Management and Budget Circular No. A-123 Revised (A-123), and the Federal Managers' Financial Integrity Act of 1982 (FMFIA). Our audit covered HUD's internal control evaluation activities since the issuance of our last A-123/FMFIA audit report on December 12, 1986. We also considered the cumulative results of HUD's process from its inception in Fiscal Year 1983. The purpose of our audit was to determine whether the evaluation process provided a basis to form conclusions on the effectiveness of HUD's systems of internal control. Specifically, we reviewed: (1) the status of HUD efforts to design and implement an effective process for achieving A-123/FMFIA objectives; and (2) the extent of internal control review coverage of HUD program and administrative areas.

HUD's process provided a basis to form conclusions on the adequacy of systems of internal control in those assessable units, or components thereof, evaluated to date. The Office of Administration anticipated that completing evaluations of all 62 originally identified highly vulnerable assessable units would provide sufficient evaluation to reach conclusions on the adequacy of HUD's overall internal control system. Although evaluations were scheduled to complete coverage of the 34 remaining highly vulnerable assessable units in Fiscal Year 1987, ten evaluations were yet to be completed as of November 18, 1987. Furthermore, our review of 14 internal control reviews found that most were limited in scope and did not represent a review of the total system of internal control within an assessable unit, or were otherwise incomplete.

The implementation of HUD's revised process for future evaluations needs to be completed. Circular A-123 was revised in August 1986 to provide for better planning and execution of the evaluation process. The Management Control Plans are to be in place by December 31, 1987. The OMB guidelines also require a re-evaluation of the vulnerability of each assessable unit every 5 years. At the beginning of the year, the Office of Administration anticipated that it would develop and implement a new planning system and complete vulnerability assessments during Fiscal Year 1987. Actions in process to complete the implementation of the revised process at the conclusion of Fiscal Year 1987 included:

- Performance of risk assessments on HUD's revised inventory of assessable units.
- Compilation of completed alternative internal control review (AICR) activities for assessment against the inventory of assessable units.
- Preparation of Management Control Plans (MCP) for each Headquarters Principal Organization Head (HPOH), showing the risk and planned schedule of internal control reviews (ICRs) and AICRs for HUD's inventory of assessable units over a 5-year cycle.
- Definition of all identified material weakness areas in terms of specific internal control deficiencies and corrective actions necessary to improve the applicable system of internal control.

The completion of these actions was extended into Fiscal Year 1988, as efforts were concentrated on formally documenting and explaining the revised process, and completing ICRs and AICRs on the previously identified highly vulnerable areas as a possible basis for providing the required A-123/FMFIA assurances for Fiscal Year 1987.

We believe that the incomplete implementation of HUD's evaluation process and the limited nature of ICR activities should be considered by HUD management in the Fiscal Year 1987 reporting of whether or not their systems of internal control, taken as a whole, provide reasonable assurance that:

- Obligations and costs are in compliance with applicable law;
- Funds, property and other assets are safeguarded; and
- Revenues and expenditures applicable to agency operations are properly recorded and accounted for.

Although management commitment to the process increased in Fiscal Year 1987, we believe that the limited progress of the past 5 years warrants consideration of making HUD's revised evaluation process a major Departmental initiative for Fiscal Years 1988 and 1989.

We provide 10 recommendations for management's consideration in further implementing A-123/FMFIA at HUD.

1988

EXECUTIVE SUMMARY

We audited HUD's process for evaluating its internal control and financial management systems, which is required by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), as implemented through the Office of Management and Budget (OMB) Circulars No. A-123 Revised on Internal Controls (A-123) and No. A-127 on Financial Management Systems (A-127). Our audit concentrated on evaluation activities since our last audit coverage which included A-127 activities through Fiscal Year 1986 and A-123 activities through Fiscal Year 1987. The objectives of our audit were to:

1. Determine the adequacy of HUD's evaluation process for providing a basis to form conclusions on compliance with FMFIA objectives;
2. Validate the A-127 portion of HUD's Fiscal Year 1987 Annual Statement of FMFIA compliance; and
3. Advise HUD management on the content of its Fiscal Year 1988 Annual Statement on FMFIA compliance.

HUD made significant progress in evaluating its internal control and financial management systems in Fiscal Year 1988, including the completion of:

- A 5 year Management Control Plan (MCP) for the period 1988 through 1992;
- New scoping, reporting and quality review guidelines for "assurance reviews," which better address the overlapping requirements of A-123, A-127 and OMB Circular No. A-130 on Federal Information Resources.
- Forty-nine internal control reviews (ICRs), including 25 of 30 ICRs scheduled for Fiscal Year 1988 in the MCP;
- Forty-seven alternative ICRs (AICRs), including 46 of 70 AICRs scheduled for Fiscal Year 1988 in the MCP.

However, in our opinion, HUD is not yet in a position to provide reasonable assurance of its overall compliance with FMFIA objectives because:

- ICRs or AICRs have not been completed on approximately 63 percent of HUD's inventory of assessable units, with some high risk areas still not evaluated;
- Detailed A-127 evaluations have not been performed on two of HUD's eight existing financial management systems; and
- Internal control weaknesses and financial management systems nonconformances of a significant nature are not yet corrected.

We believe HUD's existing evaluation process should be strengthened to increase its effectiveness, thereby achieving full compliance with FMFIA objectives. Specific areas for improvement are discussed in the Finding section of this report along with our recommended actions, which include:

- Reorganization of HUD's process along systems rather than organizational lines;
- Simplification of the process for formulating MCPs;
- Phase-out of contracted evaluations in favor of greater management self-evaluation; and
- Implementation of an ongoing tracking and reporting system for evaluation activities.

In the interim, we advise HUD management to limit its Fiscal Year 1988 reporting of FMFIA compliance to:

Section 2 (Internal Controls) - Reasonable assurance of compliance with internal control objectives for those responsibility centers, or subcomponents thereof, which have been evaluated, except for material weaknesses identified; and

Section 4 (Financial Management Systems) - Substantial conformance with financial management systems objectives except for nonconformances in the areas of: systems integration; systems integrity; compliance with accounting principles and standards; and general ledger control.

As of the completion of our field work on December 23, 1988, your key staff responsible for A-123 and A-127 were generally in agreement with reporting along these lines for Fiscal Year 1988.

Senator GRAHAM. Thank you very much, Mr. Adams.

Mr. Greer, did you have any comments?

Mr. GREER. No, sir. Nothing in addition.

Senator GRAHAM. Mr. Martin.

Mr. MARTIN. No, sir.

Senator GRAHAM. Mr. Adams, you referred to the change in attitude that you have seen at HUD with the new administration of Secretary Kemp. Could you give us any additional examples of instances which caused you to believe that the previous administration did not have a commitment to identifying control problems and addressing them?

Mr. ADAMS. First of all, as I mentioned earlier, I think they had more of an emphasis on reducing the size of HUD and that put them in direct conflict probably with addressing the material weaknesses and the internal controls, because many of those issues do require staff to do those kind of things.

Second, they brought with them what I perceive as a lack of management experience and appreciation of the need for effective internal controls.

Then, last, I was concerned because they viewed identification of those material weaknesses as kind of personal challenges to them individually and their credibility and their management of the programs. They didn't want to recognize the problems; they saw it as a loss of face.

Senator GRAHAM. To what degree do you believe that there was a relationship between a general lack of support for the substantive programs of the Department and the lack of commitment to effective management of the Department and its programs?

Mr. ADAMS. I think, in many situations the administrators found themselves with programs they didn't particularly care for. They may have even proposed termination or reduction of those. And in the process, they found themselves with those programs to administer, and they had little, if any, interest in the effective management of those programs.

Senator GRAHAM. When the people responsible for managing the program essentially don't believe in or support or advocate continuation of those programs, what additional responsibility does that impose upon others who have oversight responsibility?

For instance, in your own position, would you see your role as being any different in a situation where you started with essential nonsupport of the programs? If you were the inspector general of the Defense Department and, suddenly, the Secretary of Defense was a pacifist, would that require any different standard for your oversight?

And, similarly, for Congress?

Mr. ADAMS. I think very much so. I think it strains the relationship, because if you make a constructive recommendation, there's a tendency not to want to accept that recommendation because of the perception of the program. We're out there to improve the economy and efficiency and the operation of that program, and to ensure that congressional intent is carried out in the process.

So there might be a reluctance to provide the staffing that it might require.

Quite often, I have observed that, if the administration proposes to terminate or reduce a program, they will have a corresponding reduction of staff. However, when they get the program back, they may not reassign the staff back to that program.

So I think it does create a more hostile environment to work in. And unless the Congress or someone else expresses some concerns about it, they believe their actions have been accepted and they have a blank check to proceed upon the lines they are following at that point.

Senator GRAHAM. What is your office's role in developing this annual manager's report?

Mr. ADAMS. In addition to the input that we provided throughout the year for the identification of material weaknesses, we only became involved in the compilation of the report kind of after the fact, in the situation of the review of the statements and assurances provided by the Assistant Secretary working with the staff compiling the report.

If we believed there were additional weaknesses that should have been identified, we would identify those and then discuss those with the staff.

Last, we would probably comment on the report and forward it to the Secretary for his or her signature.

Senator GRAHAM. In light of your experience, do you feel there should be any change in the relationship of your office to this report?

Mr. ADAMS. I don't perceive any immediate need to change anything. Once again, it was only through the quality of the work done by the audit staff and the insistence that certain things be included that those were included. And I think it requires that sort of thing if the act is to be effective.

Senator GRAHAM. Senator Mack.

Senator MACK. Thank you, Senator Graham.

Let me start by asking you this question. The law, which I guess was passed in 1982, 1983, FMFIA?

Mr. ADAMS. The Federal Managers Financial Integrity Act, yes.

Senator MACK. From your perspective, are there really teeth in that law in the sense of, once problems have been identified, that there is a mechanism to assure that they are corrected?

Mr. ADAMS. No, sir. I think that, in our situation, the reports were sent forward. They identified the material weaknesses. Certain commitments were made on the part of the Department. And no one ever followed up on those.

So I don't think there are any teeth in the sense unless someone expresses some interest in those and some follow-up to them, that there will ever be.

We were one of the few departments to identify any substantial materials weaknesses. Many of our counterparts identified few, if any.

Senator MACK. Do you believe there should be a system that puts some enforcement, if you will, into that process?

Mr. ADAMS. Yes, and I think that should take the form possibly of some oversight in some of the processes, either appropriations or other oversight, as the departments and agencies come forward through the budgetary appropriations process. Someone should raise some questions or there should be some periodic oversight by the Congress. And, auditors.

Senator MACK. Again, in reviewing some of the materials, it appeared to me that there were several instances that reoccurred year after year after year of failure for the accounting system, for example, to comply with generally accepted accounting principles, and things of that nature.

And, again, it would go year after year after year.

I tried to look at it from the standpoint of I spent a few years in the banking business and we would have both auditors that we would hire to come in and have an outside review. We were constantly being examined by the National Bank Examiners, the Government authority.

When the report was completed, the report not only went to the management of the bank, but it also went to the board of directors at the bank. And specifically to an audit committee, if you will.

As a result of that, there was a mechanism, if you will, on the part of the board to make sure that the suggestions that were made in those examination reports were, in fact, followed up on. And in thinking it through, you mentioned a little bit earlier, I'm wondering if there shouldn't be a requirement—and maybe this already occurs—a requirement that this report go to the Office of Management and Budget and there be some authority on their part to follow through with the suggestions that have been made by the audit.

Any reaction to that?

Mr. ADAMS. I'm not aware of any requirement, just as a point of clarification. But I think we are presently sharing that with the management and budget side of OMB. They have the benefit of those as they proceed with budgetary preparation.

Senator MACK. Again, just drawing on your experience then, how many years have you been doing this, completing these reports? Ever since the law was put in place?

Mr. ADAMS. Since 1983.

Senator MACK. You've been there since 1983?

Mr. ADAMS. Yes, sir, as either the deputy or the inspector general.

Senator MACK. Was there ever any response from OMB with respect to——

Mr. ADAMS. None that I can recall. I would defer to Mr. Greer or Mr. Martin.

Are either of you aware of any?

Mr. GREER. No, sir, I'm not.

Senator MACK. Was there any requirement?

Mr. GREER. No, there's no requirement. OMB provides the guidelines for the implementation of the circulars 123 and 127, but in that guidance there is no requirement that they themselves follow up on the reports that are submitted to them either by management in their letters or by the Office of Inspector General, whoever might audit the process.

There is no requirement on OMB to follow up.

Mr. ADAMS. I'll defer to Mr. Martin. He has a comment to make.

Mr. MARTIN. I believe OMB this year, in reaction to the HUD scandals and everything, has initiated a new requirement that, in budget submissions, agencies identify the resource needs to address material weaknesses. I believe Richard Darman has enacted that.

Senator MACK. Say that again? I'm sorry?

Mr. MARTIN. I think Mr. Darman has enacted the requirements that agency budget submissions identify resources needed to address material weaknesses identified in their FMFIA reports.

Senator MACK. Again, I want to be sure I get the picture straight. You prepared the report. You determined where these weaknesses are and submit that to HUD?

Mr. ADAMS. We review HUD's FMFIA process one through an audit. We are also responsible for internal controls for our own organization. I provide to the Secretary a letter of assurance as concerns the internal controls of my own organization. Each other assistant secretary does likewise, and those are consolidated into one report, which the Secretary sends forward both to the Congress and the President.

Senator MACK. Do you have any responsibility then? You said a moment ago that you look at your own procedures and make sure you have the proper internal controls and that, in essence, then every other Under Secretary does the same thing with respect to his area of responsibility.

Mr. ADAMS. Correct.

Senator MACK. Do you have any responsibility then for what they have done?

Mr. ADAMS. No. We review to determine whether or not we are aware of other weaknesses in their area that they may not have identified, and we identify those for the consideration of inclusion in the report.

Senator MACK. So, if a given assistant secretary, let's say, doesn't find anything from his perspective in his area, but you believe that, in fact, there are some problems, you would state those?

Mr. ADAMS. That's correct. That's where our disputes arose in 1987 and 1988. We found a substantial number that we believed should have been included that they were not coming forth with.

Senator MACK. You've mentioned something about disagreements, confrontations that took place, I guess, in maybe 1988?

Mr. ADAMS. Yes, sir.

Senator MACK. Give me an idea of who participated in those confrontations? Where was the point of disagreement? At what level?

Mr. ADAMS. It was initially between our respective staffs at the staff level, and the number was substantially greater than that when the disagreement first occurred. At the time I became involved, there were five open issues and the confrontation was between myself, the Assistant Secretary for Administration, the Assistant Secretary for Housing and representatives of his staff, and the Assistant Secretary for Community Planning and Development and staff.

Senator MACK. Was the debate as to whether these items should be included in the report?

Mr. ADAMS. That's correct, as to whether or not they were material weaknesses warranting inclusion in the report.

Senator MACK. And you went ahead and included those in the report, as I recall?

Mr. ADAMS. We caused them to be included. The report was not mine. That's the Department's.

Senator MACK. You were reacting differently, Mr. MARTIN.

Mr. MARTIN. I just wanted to clarify it's management's report, not the inspector general's report. We only advise them on what should be in there. But it's their responsibility to compile the report and report it as they see it.

Senator MACK. Do you think you should have more control over what goes into that report? I guess, raising it again from the same perspective, in the banking business, we also had an internal auditor. Theoretically, the internal auditor was supposed to report directly to the board.

I can see real problems with the internal auditor, let's say, in a commercial bank, whose only responsibility was to report directly to, say, the chief executive officer.

Do you think you should have more of a say about what goes into these reports?

Mr. ADAMS. I think, ultimately, we do have substantial say. The concern I would have is to place more responsibility on the auditor, the IG. It would take away from management its responsibility to be sure that it has proper management controls in place. That is where the responsibility rests, with management itself.

It's nothing more than a good business practice, as you go about your business, to assure that you have good internal controls in place and, if they're not in place, to correct those.

Sometimes, a dispute arose between us and them as to the effectiveness of the solutions to those problems or whether or not the problems had been resolved.

Senator MACK. Just speaking again for a moment about either you or they identify a weakness. Someone is charged with the responsibility of developing a solution to that problem.

I assume that would be the Under Secretary in the area in which the problem had been identified. A team probably in that area.

Are you then involved in analysis as to whether that suggestion, that solution, is an adequate one at the time it's put together? Or would you only become involved, let's say, next year, when there's another review of internal controls?

Mr. ADAMS. We would become involved if it was derived from audit work that we did. For instance, the closing agent situation which the chairman referred to earlier, we had identified that back in 1987 and had received some assurances that the conditions that we identified and the recommendations that we made had been implemented.

We found out later that those actions had not been taken.

Senator MACK. That raises another point.

Should you have known that those actions either didn't take place, or that they were inadequate? Is there a system that provides you with the opportunity to make that determination, and should there be one?

Mr. ADAMS. In that particular situation, we did go back and subsequently determine that those actions were not in place and not effective. And that's a verification process after the fact.

Senator MACK. Do you think that there is a time—is it possible for you, do you believe, to have determined the inadequacy of this new procedure that they put in place earlier than you did?

Mr. ADAMS. No, I don't believe so. I think our timing was about appropriate. There's a certain amount of time that has to elapse after a change has been made before you can evaluate it to determine whether or not it is actually in place or is effective.

I think, in this situation, our timing was appropriate.

Senator MACK. Again, were you involved at all in reviewing the solution to the problem before it went into effect? In other words, did they come back and say here's what we're going to do. We think this will solve the problem.

Did you all review that at all?

Mr. GREER. At the staff level, we did.

I think one of our key roles is to try to provide advice in some areas that we feel we have some pretty good knowledge as far as internal controls go.

So, yes, oftentimes, at the staff level, we do discuss things. But it's more informal. I think what you're getting at is a formal structure. We do not do it on a formal basis.

Senator MACK. Was the feeling at the time when you reviewed those new procedures that it was going to be adequate?

Mr. GREER. A lot of the things they proposed to do in the closing agent situation, we thought that, yes, indeed, those would fix the problem. The concern we expressed later was in the implementation of those procedures.

It wasn't I think until Secretary Kemp came on board in the summer, late spring of 1989, where he made it a responsibility of the managers. And he held the managers accountable for implementing things that were supposed to be implemented, that we finally started getting the results that we thought we would get from the system.

It's really a person problem, not a system problem in that case.

Senator GRAHAM. Do you think there's any conflict in having the Secretary of the Department certify as to compliance with appropriate control procedures? Or should that be placed in some more disinterested hands, such as the inspector general?

Mr. ADAMS. Accountability is one of the aspects that Mr. Greer just touched on and I believe very strongly in that. And I believe those people who work for the Secretary, that are accountable to the Secretary, be ultimately accountable to take the corrective actions. They should cause those conditions to be corrected.

Senator GRAHAM. I was looking at the December 31, 1987 statement submitted by Mr. Pierce to the President, which contains this paragraph:

The Department has made significant progress in implementing a formal, comprehensive, and effective management control program. In addition, we have made significant efforts to achieve financial management improvement goals of the "Reform 1988" program. High priority has been given to the areas of cash and credit management and system efficiency and integrity.

Elsewhere in this 1987 FMFIA report, statements are made that:

> We can now report substantial compliance with [OMB and GAO] standards, "and" FMA accounting and reporting are substantially in conformance with [generally accepted accounting principles].

Those statements have, subsequently, in 1989, by the new Secretary essentially been rejected.

Is that correct?

Mr. ADAMS. I believe that's correct, sir.

Senator GRAHAM. If the Secretary writes to the President, and Congress, and makes statements which subsequently are proved to be untruthful, and there's no procedure to independently verify the truthfulness or the commitment to resolve identified problems, then you have created the appearance of having addressed problems by reasuring interested parties within the administration, Congress and the general public that everything is fine. In effect, these statements become essentially a smoke screen to cover reality.

Mr. ADAMS. I can give a little bit of clarification, if I might, Mr. Chairman. I believe that quote refers to the financial management systems of the Department. Our 1987 audit did not cover that particular aspect because HUD's contractor's work was not completed at the time.

We were told by the HUD administration staff preparing that statement for the Secretary that they had sufficient knowledge of the contractor's work in order to make that statement.

As it turned out, when the contractor completed the work in early 1988, and that was not true. As we became involved in the 1988 audit, we questioned HUD statements in 1987 concerning the financial management system.

Senator GRAHAM. The precise language relative to the accounting system is, "we completed a review of our accounting systems in use during fiscal year 1987, and we can now report substantial compliance with the Office of Management and Budget and General Accounting Office standards."

What is your assessment of the steps that were taken to correct weakness reportly HUD in its annual FMFIA reports. What is the oversight system in place to see that identified weaknesses are corrected?

Mr. ADAMS. Of those identified, each year, you are required in a subsequent report to report on the status of those identified in the previous reports. I think many of the findings that were showing up in more recent reports were carryovers from previous years' reports. Various rationales were provided for the delays in taking those actions.

Once again, they were submitted that way and no one reacted to them. So, in that sense, there is an update each time the report is submitted. The whole internal control process is a cumulative thing. It's not something that happens today and it's over with.

The material weaknesses identified now will probably show up again next year because some of those are long-term fixes and are not done overnight.

Senator GRAHAM. Do you or should we have some greater solace that the management deception which occurred during the administration of Secretary Pierce will not recur either in this Department or other departments that are subject to the same managerial control standards?

Mr. ADAMS. I think there is potential for them to recur if there's a diminution of the interest at various levels. And that concerns me.

One of my concerns in many of these areas is the continuity of leadership and the emphasis placed on those.

At the current time, we have an administration that is placing a lot of emphasis on internal controls, audit resolutions and like situations.

However, I get very uncomfortable if there's a change in leadership and there's no continuity in the emphasis unless those processes are institutionalized and formalized in some way.

The strength at the present time lies in the strength of the leadership we have and not necessarily in the system.

Senator GRAHAM. Going back to that 1987 report. Do you feel that your office gave appropriate attention to the statements that were made in the letter from Mr. Pierce to the President and Congress? And if you did not catch those inaccuracies, what could be done to increase your ability to do so in the future?

Mr. ADAMS. I've reassessed that. I believe, based on information that was available to us at that point, there was nothing else we could do, because the contracted evaluation was not complete at the end of the 1987 FMFIA period. The staff who was monitoring the work for the Assistant Secretary for Administration believed, based on their knowledge of what the contractor had done, that was an appropriate statement to be made. Subsequent review by the audit staff determined those to be incorrect and misleading statements.

Senator GRAHAM. Has the character of the information you are receiving now as compared to 1987 put you in a better position to guard against the recurrence of this deception?

Mr. ADAMS. I think there's more openness, a more receptive nature to the current management. And I don't think we have those kind of problems at the present time.

Senator GRAHAM. That's a difference in personality and attitude. But, systemically, are you getting any different information than that which was available to you in 1987?

Mr. GREER. I don't think so, Senator. Not that I'm aware of. You're talking about a system that is pretty complicated when you talk about the divisions between the executive branch and Congress, and you have OMB in the middle somewhere.

The entire FMFIA Act needs to be probably tightened up a little bit.

Senator GRAHAM. I would be interested in your recommendations on what modifications should, based upon your experience, be considered in the FMFIA act.

Mr. GREER. I think our key recommendation would be oversight on the part of oversight committees, as Paul mentioned, in the budget or appropriations process, and by OMB as they go through the same processes. In situations like what happened at HUD, that type of follow up is indeed needed.

I guess more importantly, and something that Paul alluded to in his opening statement, was that the staff has got to be made available if you want internal controls to work. At some point in time, someone is going to have to be measuring the level of effort it is going to take to make sure that every dime is accounted for and at what level of risk you want to counterbalance the level of staff.

I think one of the problems at HUD is that at the same time we were going into new programs and getting away from internal controls, at the same time staff was being cut. So you had the two things going on at the same time, and they are just the opposite of what you would hope would happen in internal control systems.

Senator GRAHAM. Senator Mack.

Senator MACK. For the law or for the process to be tightened up, does it really require that we do anything from the legislative standpoint? I guess what I am saying is, the importance I guess I place on this is that people do what you "inspect" not what you "expect."

One could make the argument that we go to the next step and specifically say that the report has to be reviewed by OMB, and certain steps must be taken in following that up. Or, one could take the position that, look, OMB really already has that responsibility, No. 1; and No. 2, those of you in Congress who sit on various oversight committees have responsibility, as well. You should have been looking at those reports. You should have reacted to year after year after year to the same weaknesses being pointed out and nothing having been done.

So I guess really the bottom line of the question is: Do we really need to be more specific as to who has the direct responsibility? Or is it really already there and people just fell down on the job?

Mr. ADAMS. I share your concern. I believe the responsibility is there for all of us to play a role in that process. If it breaks down at one point, then the whole process breaks down.

Senator MACK. Your concern right now is, you are more comfortable about what is happening because you sense from the people who are—Secretary Kemp and Under Secretary DelliBovi have expressed not only in words but in deeds, so far, a commitment to see that proper internal controls are in place and that there are follow-up mechanisms once weaknesses have been shown to develop plans to solve those problems and follow up beyond that. But that is only going to last as long as, let's say, that management team lasts.

There is no guarantee a number of years down the road that we would not be back in the same situation as we have been discussing these last few years. Again, bottom line, do we need to be specific in coming up with a solution to in essence codify the approach to how to solve these problems so you do not have to worry from year to year that the routine is not in place?

Mr. ADAMS. That is a tough question. I am not clear what the logical recommendation would be, but I do think we need to institutionalize the process. I am not sure whether, legislatively or otherwise, we need to bring structure to it and institutionalize it so we can have some assurance—and when I say "we," I mean the collective "we"—that the process will continue irrespective of who is in a leadership role.

Mr. GREER. If I might, Senator, I think the General Accounting Office has a much broader view of this. We have a narrow view at HUD, and I think we would have some opinions, but a much broader view has been expressed by GAO and you can hear from them later on this afternoon. They have made some solid recommendations that I think need attention.

Oversight is one of those. Placing accountability at a level within a department—in other words, the chief financial officer concept—I think is also one that we would endorse as possible fixes in FMFIA.

Mr. ADAMS. The chief financial officer would also give you some of that institutional continuity in the process. There are probably other ways, but that seems the most readily available one, fixing it at some level like that.

Senator MACK. You perform annual audits? Is that right?

Mr. ADAMS. Yes, sir.

Senator MACK. And you play a role in the development of this management report. Is it conceivable that those should be pooled into one again? I have seen annual audits that go into some rather significant detail with respect to internal control mechanisms. Would there be anything wrong with both of these being brought into one report, or included in the annual audit?

Mr. ADAMS. The annual audit that we do is of the FMFIA process, but in addition to that audit we do look at the internal controls of the particular program that we are looking at at that point. So it is not just "a" process, it is an ongoing thing that we are doing here.

For example, this week Mr. Greer and his staff might look at the internal controls with respect to the title X program. Next week it will be in connection with the Comprehensive Improvement Assistance Program. Then, they also will be looking, as we draw near the end of the year, at the Department's implementation of the Federal Manager's Financial Integrity Act, which is a broad look at that process and how HUD will go about getting the report together, accumulating all the material weaknesses and correcting those weaknesses.

Senator MACK. There was one suggestion here that you made with respect to the financial officer. The chief financial officer possibly could pull together and institutionalize a mechanism for follow-up.

Mr. ADAMS. I think it is envisioned at the present time that the new chief financial officer of the Department, a position now being filled, will have responsibility for internal controls and material weaknesses and in the developing and reporting on corrective actions at the Department. That is envisioned, I believe, as being a career person who might bring that continuity that you might not otherwise have.

Senator MACK. Thank you.

Senator GRAHAM. On the charts are listed ten of the existing material weaknesses as identified in the 1989 FMFIA report.

Do you have any comments as to steps which have been taken, to your knowledge, to correct those identified weaknesses?

Mr. ADAMS. Chris, would you like to address some of those? I recognize most of those as being from work that our staff performed to identify those. I can quickly tell you that.

Mr. GREER. If you would care to discuss any one of those in particular, yes. We have actions going on at HUD to correct all ten of those. On coinsurance, for example, Senator, you had a hearing recently on that. That program has in fact been terminated. That will create a situation where those weaknesses have gone away, so to speak, but it has created a whole new series of problems in how to deal with terminating programs. But, yes, there are actions going on at HUD to correct all of those.

Senator GRAHAM. Item No. 4 is the section 8 program which we have also had some hearings on. Any comments about what steps have been taken to deal with those weaknesses?

Mr. GREER. I can comment about what I know about what is going on. I am sure Under Secretary DelliBovi can expand on that, if you wish, but there is currently some contractor work going on to study the whole process from A to Z. They are going to document the process and make sure that the appropriate controls are established at each level within the process itself. That is one of the priority items going on at HUD right now.

Mr. ADAMS. I might expand upon that. Each of the material weaknesses identified in that report, or subsequently identified, are captured in the Secretary's management report on material weaknesses. Each of those identified subcomponents of that has a timeframe. It is something for the Secretary and Under Secretary to use to track the progress of those, and that is prepared on a biweekly basis and provided to the Secretary and the Under Secretary and all other principal staff that are involved in addressing those issues. So there is a mechanism in place to monitor and track them on an ongoing basis. And biweekly progress reports are being made toward the resolution of those.

Senator GRAHAM. That system has been in effect for some time?

Mr. ADAMS. Just begun this year, 1989, late in the year. That is the formal process. There had been a less formal process before that.

Senator GRAHAM. The experience of the 1980's indicates that clearly such a process is called for. Do you do any overview of that monitoring process to independently assess the degree to which effective corrective action is being taken?

Mr. ADAMS. We do. Again, that is driven in large part by the fact that many of the material weaknesses are derived from the audit work the staff did. So many of the recommendations are tied directly back to open audit recommendations, and we are involved in the resolution of those and will have to concur in the planned corrective actions and their implementation.

Senator GRAHAM. I have no further questions. Mr. Adams, thank you, very much.

Mr. ADAMS. Thank you, sir.

Senator GRAHAM. Our second panel today consists of representatives from HUD management. These are the individuals responsible for putting together HUD's FMFIA reports. We have today Mr. DelliBovi, the Under Secretary for HUD, and Mr. Harold Henry, whose office compiled HUD's 1989 report. We also have present Janice Combs whose office was responsible for compiling FMFIA reports during the Pierce administration.

At this hearing, as is standard in the Banking Committee, we are swearing witnesses. Would you please raise your right hands.

TESTIMONY OF ALFRED DELLIBOVI, UNDER SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT; ACCOMPANIED BY HAROLD HENRY, DIRECTOR, OFFICE OF MANAGEMENT AND QUALITY ASSURANCE, HUD; AND JANICE COMBS, DIRECTOR, FINANCIAL MANAGEMENT SYSTEMS, OFFICE OF FINANCE AND ACCOUNTING, HUD

Senator GRAHAM. Mr. DelliBovi, thank you very much for your return visit.

Mr. DELLIBOVI. Thank you, Mr. Chairman.

Senator Mack, I would ask that my statement be included for the record. I would just like to go over a few of the points.

Senator GRAHAM. It will be.

Mr. DELLIBOVI. Mr. Chairman, members of the subcommittee, I appreciate the opportunity to appear before you to discuss HUD's internal controls program and to tell you about the actions HUD has taken Under Secretary Kemp to improve financial management.

I know you have looked at a copy of Secretary Kemp's 1989 annual assurance letter to the President and the Congress. If you look at that letter and compare it with previous letters, what you will quickly see is a very honest and objective appraisal of the situation at HUD as we saw it in the closing days of calendar year 1989.

Jack Kemp did not wait for the IG to identify material weaknesses. Management, working with the IG and the GAO, identified 11 of the 21 new weaknesses reported in 1989. Of the other 21 weaknesses which we inherited, only 2 were identified by management. So I think you can see from that report that Jack Kemp is taking this process very seriously.

I could not help but hear some of the questions to the other panel with regard to the Office of Management and Budget. Let me add that Director Darman takes this process very seriously. Indeed, last July I was called upon in a Cabinet meeting by the President to describe some of the problems at HUD and some of the remedies that we were proposing in terms of approaches.

The Director of the Office of Management and Budget, Mr. Darman, called together all of the number two officials from all the departments, the under secretaries or deputy secretaries as the case may be, last summer with all of the IGs. Mr. Adams and I made a presentation to them about what we were finding at HUD and how we were going about correcting it.

So there is top-level attention not only at the Department but at the Office of Management and Budget level. And as I indicated, the President has brought this to the attention of the Cabinet on at least one occasion where I was present.

Turning back to HUD, as soon as I was confirmed as the Under Secretary, I was designated as the Department's audit follow-up official. I do not know if anyone had that designation before, but I got it last June. I immediately designated a special assistant, a career special assistant that I had brought to the Under Secretary's office, as the audit and liaison officer for the Department. I implemented a series of steps designed to clear HUD's backlog of outstanding audit recommendations and, in so doing, to underscore management's commitment to the follow-up aspects of the audit process.

I would like to give you some specifics about our improvements. As the previous panel I believe indicated, the single most significant improvement—and it is one the IG had advocated at HUD for years—is top management attention to internal controls and accountability for ensuring that the controls are adequate.

Lack of management attention has been the major failing of HUD's management program in the past, and it has been the major change that Jack Kemp has brought to HUD. We are attentive to these issues. The Secretary has instructed the Assistant Secretaries at HUD to consider plans to correct material weaknesses as top priorities, and he is holding his management team accountable for the completion of this task.

The responsibility for ensuring that controls are adequate has been integrated into our overall departmental management and planning activities. I believe that this integration is at the very heart of a successful internal controls' program, and it is something to which the Secretary and I are very strongly committed.

I have directed that each assistant secretary designate a top-level manager or special assistant to coordinate the internal controls' program within each office, so there is one person in each place held accountable. And my office has, as I said, someone designated the same way.

Another very important improvement in our internal controls' program is that we have developed a completely new tracking system to monitor completion of corrective actions and scheduled internal control reviews. There was no tracking system that I could find when I got to HUD. This is frankly my most important tool for holding managers accountable for results. Each month, the Secretary and I receive a report on material weaknesses. It contains not only the status of each corrective action, but also an executive summary highlighting progress and slippages, mileposts that have been met, and those that have been missed. We know exactly where we are at all times. And, more importantly, we see where we fell behind.

I use this report to follow up with the assistant secretaries to make sure that we are resolving problems expeditiously. We do not permit HUD managers to lose sight of the importance of correcting these material weaknesses. We do not allow them to sweep them aside or under the carpet.

I have also established a process for addressing new material weaknesses quickly. We have notified the principal program staff that they have 30 days from the time a weakness is identified to submit a corrective action plan to me for approval as they are identified. We are very much aware of the poor track record of HUD's internal controls' program in the past, but I want to assure you that it has changed. You will see a marked improvement in our compliance with the Federal Managers Financial Integrity Act, in our 1990 assurance letter, and I can assure you that Secretary Kemp is not just putting bandaids on these problems. He is directing HUD at all levels to make the institutional changes which will prevent a recurrence of the scandalous situation which this administration inherited.

That concludes my remarks. I will be happy to answer any questions.

[The prepared statement of Alfred DelliBovi follows:]

TESTIMONY OF ALFRED A. DELLIBOVI AT THE

HUD/MOD REHAB INVESTIGATIVE SUBCOMMITTEE OF THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

HEARING REGARDING HUD INTERNAL CONTROLS: SELF EVALUATION

INTRODUCTION

Mr. Chairman and members of the subcommittee, I appreciate the opportunity to appear before you to discuss HUD's Internal Controls Program and to tell you about the actions HUD has taken under Secretary Kemp to improve financial management.

If you have read a copy of Secretary Kemp's 1989 annual assurance letter to the President and Congress and compared it with previous letters, you will quickly see an honest and objective appraisal of the situation at HUD. Jack Kemp didn't wait for the IG to identify material weaknesses. Management identified 11 of the 21 new weaknesses reported in 1989. Of the other 21 weaknesses which we inherited, only 2 were identified by management. You can see that Jack Kemp is taking this process very seriously.

HUD has made good progress in correcting the 42 material weaknesses reported in 1989. Of the 206 milestones listed in the corrective action plans, 125 (or 61%) have been completed. We are well on our way to resolving the 10 most serious material weaknesses.

GENERAL FINANCIAL MANAGEMENT IMPROVEMENTS

First I would like to outline the general management initiatives Secretary Kemp has implemented to improve financial management at HUD; then I would like to detail the specific changes we have made to improve the Internal Controls Program.

Established Chief Financial Officer Position

HUD is in the process of selecting a Chief Financial Officer who will be charged with establishing sound financial management policies and systems in the Department and for ensuring that internal controls are adequate. This kind of high level financial management oversight has been missing at HUD; and I believe that the CFO structure is a major step to improving the financial well-being of the agency.

Established Program Comptroller Positions

A Comptroller for the FHA, who will be responsible for the financial systems and internal controls in the Housing programs, will also be selected soon. Similar Comptroller positions in Public and Indian Housing, GNMA, Community Planning and Development, and Administration were recently advertised. Over 1,000 applications for those 4 positions have been received. When all of these Comptrollers are in place, they will complete HUD's financial management organization.

Initiated Program Financial Management Improvements

Another major management improvement initiative, the Secretary's Task Force on Program Financial Management, is nearing completion. Plans proposing more than 1,000 actions have been developed for the 26 financial management areas reviewed. The process of determining which actions to adopt and establishing priorities for implementation has begun.

Documented Workflow, Finances, and Controls

Along with the Action Plans developed by the Task Force Working Groups, the Office of Management and Quality Assurance is preparing program analysis summaries which document workflow, internal controls, and major financial information about each program. These program summaries will serve a number of purposes, including helping managers identify internal controls deficiencies. The Task Force action plans and the financial leadership which the CFO will provide are important steps in laying a solid financial management foundation at HUD.

Improved Audits Resolution Process

As soon as I was confirmed as Under Secretary, I was designated as the Department's Audit Followup Official. I designated one of my special assistants as the Audit Liaison Officer for the Department, and I implemented a series of steps designed to clear HUD's backlog of outstanding audit recommendations and underscore management's commitment to the audit followup process. The Secretary's first semiannual report to Congress, published in November, documented our improvements.

SPECIFIC IMPROVEMENTS MADE IN THE INTERNAL CONTROLS PROGRAM

Assigned Top Management Accountability

Now let me give you some specifics about our improvements to the Internal Controls Program. The single most significant improvement - one which our IG has advocated for years - is top management attention to internal controls and accountability for ensuring that controls are adequate. Lack of management attention has been the major failing of HUD's program in the past, and Secretary Kemp changed that. The 1989 assurance letter is evidence of that fact. Both the Secretary and I personally devoted a great deal of our time and attention to preparing that letter and to ensuring that the corrective actions documented in that letter were both adequate and timely.

The Secretary has instructed the Assistant Secretaries at HUD to consider plans to correct material weaknesses top priority, and he is holding his management team accountable for the completion of this task. I have issued written management planning guidance which includes the Internal Controls Program among HUD's top management priorities. The responsibility for ensuring that controls are adequate has been integrated into our overall Departmental management planning and accountability. Ensuring financial integrity of our processes and systems is our major concern as we allocate our resources and set our management priorities. I think that this integration is at the very heart of a successful Internal Controls Program, and Secretary Kemp and I are committed to it.

Designated Senior Level Coordinators

I have directed each Assistant Secretary to designate a top level manager or special assistant to coordinate the Internal Controls Program within each office. Once the Comptrollers are selected, each Comptroller will assume the responsibility for overseeing internal controls in his program area, and the CFO will chair a Council of Comptrollers which will function as a steering committee to provide guidance and direction for the Internal Controls Program Departmentwide.

Established "Arms Length" Internal Controls Function

Last summer, responsibility for the Internal Controls Program was transferred from the Office of Finance and Accounting (OFA) to the Office of Management and Quality Assurance. This was done for three reasons. First, I wanted the management analysts in that Office to review the program and offer recommendations for ways to improve its effectiveness. Second, I wanted to give it the management focus it deserves. Third, I wanted to remove the Internal Controls Program organizationally from the Departmental accounting operations. I saw a real conflict of interest in having both the accounting operations and the Internal Controls Program under the same management umbrella.

Established Effective Tracking System

Another very important improvement in our Internal Controls Program is that we have developed a completely new tracking system to monitor completion of corrective actions and scheduled Internal Controls Reviews. This is my most important tool for holding managers accountable for results. Each month, the Secretary and I receive a Report on Material Weaknesses, which contains not only the status of each corrective action, but also an Executive Summary highlighting progress and slippages. I use this report to follow up with the Assistant Secretaries to make sure that problems are being resolved expeditiously. I do not permit HUD's managers to lose sight of the importance of correcting these material weaknesses.

There were a number of other problems with the Internal Controls Program as we found it.

Redefined Activities to Be Reviewed

The breakdown of HUD's programs and functions into activities subject to review under the Internal Controls Program had been done in such a way that important linkages and program life cycles had been ignored. Program activities had been broken into 246 separate review areas (known in the jargon of the Internal Controls Program as "assessable units"). Those activities were regrouped in a more meaningful and logical way and 65 inherently high risk areas which equate to major program functions were identified.

Targeted High Risk Areas

We are targeting our reviews in a more rational way. I have asked the Assistant Secretaries to schedule an Internal Control Review of each high risk review area within the next 3 years. We will not stretch these reviews out over 5 years, as permitted by the OMB circular.

Expanded Scope of Reviews

Future reviews will be much more comprehensive than those in the past. I have instructed Assistant Secretaries to look not only at how internal controls for a program are designed, but also at how they actually function. HUD did not require substantial testing of controls in the past, as part of the review process. This is no longer the case. We are working toward the development of self-assessment guides so that our Field managers can conduct regular evaluations of the effectiveness of their internal controls.

Institutionalized Process for Addressing New Material Weaknesses

I have established a process for addressing new material weaknesses quickly. I have notified the Assistant Secretaries that they have 30 days from the day the weakness is identified to submit a corrective action plan to me for approval. Once I have approved the plan, it will be incorporated in the Secretary's Management Report on Material Weaknesses. Then my staff and I will meet with top managers on a regular basis to go over their progress in eliminating material weaknesses.

Enhanced Verification Reviews

Once material weaknesses are corrected, an independent verification review will be initiated. HUD no longer will rely on the confirmation of Internal Controls Coordinators within program areas to close out a material weakness. The weakness will continue to be tracked until the verification review has been completed and a positive report received.

CONCLUSION

I am very much aware of the poor track record of HUD's Internal Controls Program in the past. It has changed. You will see marked improvement in our compliance with the FMFIA in our 1990 assurance letter. Secretary Kemp is just not putting band-aids on our problems. He is directing HUD to make institutional changes which will prevent a recurrence of the scandalous situation which this administration inherited.

That concludes my remarks. I am happy to answer any questions you may have.

Senator **Graham**. Mr. Henry or Ms. Combs, do you have any comments you would like to make?

Mr. **Henry**. No.

Ms. **Combs**. No, I do not.

Senator **Graham**. Mr. DelliBovi, the charts indicate 10 of the areas which were identified in your 1989 report as being material weaknesses. Can you comment as to where the Department stands in correcting the weaknesses that were identified?

Mr. **DelliBovi**. We are moving on each and every one of them. I would be pleased to go over any one or all of them with you, or to submit a summary for the record, whichever you prefer.

Senator **Graham**. I would appreciate receiving a summary on each of them that we could incorporate in the record of this hearing.

Numbers 4, 5, and 6 have been particular items of previous hearings. We know what has happened with No. 5. Would you tell us what has occurred with Nos. 4 and 6?

Mr. **DelliBovi**. I would be happy to, No. 4 is the section 8 subsidy process.

The problem with section 8, very briefly, was there was no uniform process for reviewing and certifying the accuracy of the payment requests. Senator, I know you have made it a habit in your public career to do different jobs. Any one of those private enterprises that you have had the experience of working with, would have been out of business if they tried to run this thing the way the section 8 program was operated or is operated.

It is just a disaster the way that program has been operated. There is no requirement for the field offices to review or approve payment requests prior to payment. There is no process to reconcile payment requests. The program management and accountability is fragmented within HUD between the headquarters and the field. We pay, as a result, excessive subsidies. Tenant income is underestimated. Ineligible tenants get admitted into the housing. Payments are made for items that are not eligible. HUD is unable to detect or collect the overpayments, and payment requests from the PHA's and the owners are not processed timely and, when they are processed at all, not accurately.

We tinkered around internally to try and straighten this out, and quite honestly we had to throw up our hands several months ago and realize we had to bring in an outside consultant, which we have done, Arthur Andersen, to review the process for all of the section 8 programs—the 236 program, as well as the rent-supplement program.

The Arthur Andersen study is to be completed by June 15 of this year. That study will provide a detailed action plan which is designed to correct the problems. The timetable for implementing that action plan obviously cannot be put in place until we see the action plan, but that is the status of that program. That is a nightmare.

Senator **Graham**. So in summary you have contracted with an outside accounting firm to develop specific steps to mitigate the weaknesses that have been identified?

Mr. **DelliBovi**. To review it from A to Z and tell us how it should be run right. They are obviously working closely with our staff. We had some ideas, and I certainly would not want to leave you with the impression that the staff could not figure out anything to do, but no one was comfortable enough with the staff recommendations to say this will definitely fix it. We felt that we had to contract outside to get independent review of what was being proposed, and an implementation plan to do what we want to do to fix it.

Senator GRAHAM. And that plan you anticipate being available in June?

Mr. DELLIBOVI. June 15 is the contractual date.

Senator GRAHAM. Could you comment on No. 6 under the numerical listing of the chart, which is the section 8 Mod Rehab Program.

Mr. DELLIBOVI. That is the Mod Rehab Program. As you know, the problem there was ineffective monitoring and regulation enforcement by our field offices, insufficiently trained field and PHA staff.

The impact of those problems was project selection often based on favoritism, excessive subsidies, and lack of cost containment.

Our action plans to correct those weaknesses were cancelling the funds that were not under contract of the public housing authorities. We transferred responsibility for establishing the contract rents in the coinsured projects from private lenders to our own staff in the field offices. We assembled a team of the best, most experienced field staff who understood that program, trained the team, and sent them to visit 50 of the public housing authorities to review the projects that were in process on site.

That team reviewed the projects and, in extreme cases, contracts were terminated or we required them to go out and readvertise the contracts. We have trained an additional 150 members of our field staff who will then go out and review the rents of the 300 Mod Rehab projects that were approved since 1984. We believe these projects are where potential problems may exist.

For the future, under the reform provisions H.R. 1 which was passed last year, we are putting out two notices of fund availability which will capture the spirit of that reform. We expect that those NOPR's will be published in June, and that the review of the 300 projects, if all goes well, will be completed in December.

Senator GRAHAM. So you still contemplate there being a section 8 mod Rehab Program under the new management controls that you have outlined?

Mr. DELLIBOVI. We have not requested further funding for that program in the budget, but if there is funding provided we are going to run it; right. We still have a backlog of the old projects, and we haven't straightened those out.

Senator GRAHAM. Senator Mack.

Senator MACK. Thank you, Senator Graham.

You mentioned, I guess, the follow up for internal controls for auditing ended up being your responsibility. In searching to try to develop solutions and come to some conclusions, did you find in the past at any time that there were adequate internal controls that there was a system at some place sometime in the past in which there wasn't a reasonable approach to internal audits and a follow up? Or has it basically been nonexistent?

Mr. DELLIBOVI. Do you mean specifically with A-123? I think the best answer is that there were no management systems in place in the Department, period, or anything I could detect that resembled a follow-up system.

You mentioned, Senator, that you in a prior life were in the banking business. I am sure that there were certain reports that you looked for each day when you came to work to tell you where the business was. Cabinet officers, at least the HUD Secretary, found no such reports.

We have put in place systems now, both A-123 and for the daily management of the Department, designed to provide a monthly or biweekly report to us on management information that is being tracked. So, we know where we stand on any given management issue.

There were some funding reports that could probably give you a picture of how much money people thought was available. I guess that is fair to say. There were funding reports, but in terms of the management tasks and what is going on, and particularly dealing with solving problems, there was no management information system that I could detect.

Senator MACK. I notice again in some of the materials there was a comment made that there was no external audit of FHA since 1974?

Mr. DELLIBOVI. That is correct. Even now we are barely able to get one. The fund will be audited for the first time this year.

Senator MACK. At any point, was there any indication that anybody raised that issue in the past of why hasn't there been an outside audit of FHA? Did not the inspector general raise that? Or should he have raised that? I am still trying to get some kind of a sense about who should have been raising these questions all along.

Mr. DELLIBOVI. Well, I think that the reform we are making with the chief financial officer reflects the fact that by having a chief financial officer in place, that one of the functions of that position would be to ask these kinds of questions. I cannot with certainty tell you what happened in the Department before I came there. My understanding is that the IG was pursuing waste, fraud, and abuse.

The fact that a program or fund has not been audited does not necessarily indicate that there is waste, fraud, and abuse. However, if you do not know what your financial condition is, and you cannot tell me that there is not waste, fraud and abuse, being a skeptical guy, I would assume then that there is. I do not believe that in most cases, somebody newly appointed and confirmed as an assistant secretary has the expectations of being an audit official.

There is a tendency to want to go to ribbon cuttings and make speeches and that kind of thing. This is the drudgery of government. I mean, this is not the glamorous part of the business, but it is essential if the business is going to be run properly.

Senator MACK. OK. Maybe Ms. Combs can add a little light on this. I guess in my mind I am trying to figure out, since 20 or 30 years ago we had this system of internal controls which was providing management with the necessary information to make determinations about whether it was being properly managed or not, whether the assets were being properly guarded and so forth.

Then comes 1980 and all of a sudden all of these internal systems fail to work in the process, and we work until 1988 and the Kemp administration comes in and puts in a new set of internal controls. Is that a fair analysis? Can you respond to that, Ms. Combs?

Ms. **Combs**. The only thing I can add to Mr. DelliBovi's statement relates back to your original question on financial audits of FHA. When I was at GAO, I spent 12 years at GAO before coming to HUD. GAO, under the Government Corporation and Control Act, is required to audit FHA once every 3 years. The audits, up until I think the ones in 1987, GAO over quite a few of those years was unable to provide an opinion. In 1987 they came in under the act and this was the first time, using a contractor, they were able to begin the audit process.

They continued in 1988, and that was the year that a lot of the scandals hit. The opinion was, and I think GAO can elaborate on their opinion and how they drew it, was that they could not opine on the state of financial affairs due to the financial losses that HUD had incurred.

I do want to add that, as Mr. DelliBovi has indicated, as management's initiative in 1989 they are undertaking a financial audit of FHA. But prior to that, we had, management, with the concurrence of the inspector general, had undertaken an audit of the non-FHA activities. So we were looking into those state of affairs, and that audit was for fiscal year 1988.

Mr. **DelliBovi**. If I may make two points, I am not willing to accept that this turn of events occurred in 1980. I think if you look at the section 8 program, for instance, you will see that from the very day it started in 1974 no thought was given to how this program would be managed. For example, what would happen when the certificates expired and new budget authority was needed.

Everything was designed from the view of getting the certificates out quickly, and nobody looked 5 or 15 years down the road. Similarly with FHA, for most of the FHA's history we were in a rising real estate market. There was no premium to be paid on audited statements because the rising value of the assets frankly covered a multitude of areas of omissions. It was good for FHA to hang onto property because the value kept going up. Whenever they sold it, they probably made a profit.

Senator **Graham**. I am concerned that the management response to two of the three programs that we have specifically focused on, Nos. 4, 5, and 6 on the chart, was either to terminate the program or to not recommend any further funding, which would have the same effect, as terminating the program.

My concern is that these programs were established because somebody thought there was an unmet need. In the case of coinsurance, the Department was not able to effectively and expeditiously administer its own insurance program and there was a need to delegate to others. In the case of moderate rehabilitation, a program needed to be in place that could deal with relatively small rehabilitations required to bring living standard of rentals occupants up to a level of adequacy.

As we respond to management weaknesses by termination, does the Department have a strategy that will assure us that the underlying unmet need which had caused the creation of the program in the first place is going to be attended to in another manner, or that that underlying need no longer exists?

Mr. DELLIBOVI. Let's take coinsurance first. Coinsurance is not a program. All of us have been referring to it as a "program." It was a delivery mechanism, a scheme for insuring multifamily housing. It was one we believed that was so fundamentally flawed and unworkable that it is beyond repair.

We are right now working within the Department to develop an alternative mechanism for delivering insurance to multifamily projects through a delegated processing system. In the meantime, we have the full insurance program in place. We recognize a need to provide insurance for multifamily projects, but we simply believe that this coinsurance scheme is beyond repair and there is a better way to get the results that we all agree is needed.

Now lets take the moderate rehab program I believe the rental rehab program is a better way of meeting that goal and that is the program we are focusing on.

Senator GRAHAM. One of the recommendations that was made by panel 1, particularly Mr. Adams, was that there be adequate staff within the Department to both service these weaknesses and to oversee their correction. Are you satisfied that the budget which you have submitted to Congress for this next fiscal year will give you the capacity to do those two things: Service and respond to identified weaknesses?

Mr. DELLIBOVI. I believe it will adequately meet our needs to respond to the weaknesses we expect to have identified. I am not driven by inputs. There are many people in this town who think that the only way you can accomplish something is by more people, more travel money, more machines, more this, or more that. I like to focus more on outputs. So we define the problem and look at what we need to do to fix it.

The Secretary is not bashful in asking for additional resources, but we do not begin our problem-solving with the assumption that the only way to solve it is more resources. We think we have the resources we need to do the job.

Senator GRAHAM. I agree with you totally that performance is the standard, not process or input. But I have been in situations where, a year after things did not go as well as one would have hoped, the response was "if you had given me what I had asked for, I would not be here today submitting such a plaintif call."

I am asking you today: Are you satisfied that if you received the requested resources, that you will be prepared to be judged by the performance that those resources will achieve in terms of identifying and dealing with managerial weaknesses?

Mr. DELLIBOVI. I believe we will.

Senator GRAHAM. Ms. Combs, could you tell us what was your association with the development of the FMFIA reports during the period of Secretary Pierce's administration?

Ms. COMBS. Yes, sir, I can.

I worked within the Office of Finance and Accounting that reported to the Assistant Secretary for Administration, Judith Hoffman. The Assistant Secretary for Administration was given the overall responsibility for coordinating the FMFIA process throughout the Department.

I reported to the Director, so I was the staff person assigned to this responsibility of coordination. My role as coordinator was to disseminate information and to compile the Assistant Secretary's statement at year end for reporting purposes.

Senator GRAHAM. Did you have any responsibility or capability to do verification of the accuracy of the information which was in the report that you compiled for the Assistant Secretary?

Ms. COMBS. I did not have the staff resources to do that kind of a detailed verification that I believe would be necessary to give an adequate assurance.

Senator GRAHAM. Mr. DelliBovi, and the first panel before you, made some very devastating critiques of previously submitted FMFIA reports, particularly that for 1987. I quoted earlier some of the statements that were made in this report, including that "we can now report substantial compliance with OMB and General Accounting Office standards in terms of our accounting systems" and that "we've made a significant progress in implementing the formal components of an effective management control system."

Mr. DelliBovi said he found those statements not to be true when he arrived. If you were to hold someone accountable for those representations, who would be the responsible party?

Ms. COMBS. The leadership of the Department.

Senator GRAHAM. The letter is signed by Mr. Pierce. Do you think Mr. Pierce is the one who should be held responsible?

Ms. COMBS. Yes, sir.

Senator GRAHAM. This was a letter to the President of the United States. I assume that the President took this into account in terms of his own sense of the state of the Department and the need for his personal involvement. If I had received this letter on December 31, 1987, I would have gone to bed fairly comfortably on New Year's Eve feeling that the Department of HUD was not an area that was going to be of concern to me in the new year.

Do you think the President was deceived by this letter?

Ms. COMBS. The judgment, as I look back, made by the managers—and I believe that Mr. Adams had referred to judgments by the managers—is, in retrospect, hindsight, those judgments certainly as Mr. DelliBovi has said, you would walk in today and you would definitely know that there were problems and question a lot of those judgments.

I do not believe that "deception" is the proper word. I would like to, if I may, quote for you the final report of the contractors that were hired to take a look at our compliance with financial systems in the year of 1987, and that report concluded——

Senator GRAHAM. Excuse me. What was the name of the contractor who submitted this report?

Ms. COMBS. Watson and Rice.

> HUD's financial management system in effect as of September 30, 1987, taken as a whole, provides reasonable assurance that the policies and objectives of OMB circular A-127 were substantially achieved.

The report also concluded, however, that "HUD was not in full compliance with GAO accounting principles and standards."

I believe that the 1987 report by management was based upon that contractor's opinion. So as I say, I do not think "deception" was intended.

Senator **Graham**. In other words, if the statements were in error, the Secretary was acting on the representations made by Watson, Rice, and Company?

Ms. **Combs**. Yes, sir.

Senator **Graham**. And without an independent intent to mislead or to obscure the reality of the situation?

Ms. **Combs**. That is correct.

Senator **Mack**. Let me just follow up on a couple of those, if I could. I assume that your response is in essence that Secretary Pierce is the one who should be held responsible in the sense that he had the overall charge of the Department. Therefore, anything that does go wrong in essence is his responsibility.

What I would like to get to, at least as best you understand it, were you involved, or did you see the Secretary involved, in any kind of you might say confrontation that somebody referred to earlier, or debate about whether these comments made by the IG in fact were accurate, or whether they fairly reflected what was going on in the Department?

In other words, was there a discussion of significance at the Secretary's level on matters that concern us here?

Ms. **Combs**. I have absolutely no idea what was discussed at the Secretary's level. I can tell you that the statement that Mr. Adams made about the pull and the tug between program offices and the IG office as we compiled the yearend letter, coming up with the language and the specific material weaknesses, is correct.

But I worked with the staffs in those program offices and the staffs of the inspector general and reported progress to the Director of the Office of Accounting, who then reported progress to the Assistant Secretary, and I do not know what happened at those levels and above.

Senator **Mack**. Mr. DelliBovi, I want to go ahead and go back to the discussion I was having with the first panel about whether Mr. Adams could feel comfortable about future years. I am not talking about specifically you and Secretary Kemp. I am talking years on down the road.

While there may very well be a good system in place now and obvious concern on the part of management with respect to internal controls so that the system would not deteriorate over a period of time, or dramatically in a change of administrations let's say—given that as a backdrop, should the Congress require more specific attention by law as to follow up on internal audits the reports that we are talking about here today, and other matters?

Mr. **DelliBovi**. I think the best answer to that is through effective oversight. I have made reference in other testimony here before this committee to my life in the Department of Transportation. I can tell you that your colleague from Florida, the chairman of the Subcommittee on Appropriations, Bill Lehman regularly questioned Transportation officials from each of the modal administrations—we came before him annually for appropriations—about outstanding audits. I would not say that he went into every one of them, but he kept us attuned to internal controls.

I reviewed the appropriations testimony in the record for HUD over the last several years before I came here, and I have not seen too many questions along those lines. I would say that is one area of oversight.

You know, the problem with the statutory requirement is that you end up with another report. I do not know who reads them. One of the things we learned about the 1980's was that Paul Adams' IG reports were coming up here, as well as to the Secretary. We have put in place a mechanism that will be there for our successors. They can dismantle it if they so choose.

We have changed the culture at HUD and that is even more important to me. The organization now senses that the A-123 process is an important one that they should be attentive to. So that when new political appointees come in, the career staff will feel comfortable saying "this is an important area; you have to pay attention to this."

The truth of the matter is that when you look at what has happened since Secretary Kemp's arrival, as wonderful a guy as he is, he did not come with a magic wand. Many of these discoveries were fairly common sense. We went to the IG. We went to the GAO and said, what is wrong here? Tell us about it?

We could have gone to the ribbon cuttings only, but we looked for the problems figuring, very realistically, that if we did not find them for ourselves, someone would find them for us sooner or later. I think that part of taking over an agency, a department at the executive level, is looking for the bad news as well as the good news. You do not want to read books that are only filled with good news; you have to be a little bit more aggressive at finding the bad news.

Most of these enterprises are not running perfectly, so I really do believe that there was a cultural issue. Certainly, Ms. Combs can attest that we have raised within HUD the importance of the A-123 process is an important area that we want to pay attention to, and hopefully the career staff will feel comfortable enough with their managers in the future to carry that on. If they do not, you may want to consider action.

I would say, before I jump to legislation, I would have a more organized approach to oversight. Many committees up here on the Hill on both sides hold hearings, and hearings on these matters—probably this is the only one going on out of the hundreds of committees at 3 o'clock on an afternoon in April today—but this is to me the most effective way you really are going to get into it. Otherwise, you get a glossy report that maybe somebody will read, and maybe they will not.

Senator MACK. What about the issue of follow-up within your organization now? What have you put in place? I noticed in your testimony, or in your statement rather——

Mr. DELLIBOVI. I think Mr. Henry will be better equipped to answer that.

Senator MACK. You mentioned an effective tracking system, for example.

Mr. DELLIBOVI. The tracking system is this report on material weaknesses that is generated monthly for the Secretary. It is organized according to each assistant secretary. So it has their names on the tabs, and within it the names of whoever is responsible for it.

I have two people on my staff who spend their time nit-picking around the building. I have told them that they will both be persona non grata by the time they are done, but they go around finding out what is going on on each of these items, and that is what they do when they come to work every day.

So we have this mechanism in place to follow up and nudge, if you will, or ask the pertinent questions off of it. Mr. Henry has some other mechanisms that he will discuss.

Mr. HENRY. In the tracking systems, all the action items have been identified and target completion dates have been identified. One of the procedures that we have instituted under the Kemp administration is that once the Assistant Secretary states that all those action items have been completed, we will not assume that just because all those action items have been completed the problem has been solved.

What we will be doing and have done already as far as our contract is to go out and do a postverification survey on "has the problem now been solved?" That sort of gives us an objective balance to the process. That did not occur previously before. We would simply take the program's word that any of the problems had been solved.

Senator GRAHAM. Mr. DelliBovi, when you came to the office did you have an opportunity to review this report by Watson, Rice & Company which apparently was the basis for the 1987 letter from Secretary Pierce to the President as to the condition of the Department's internal accounting controls?

Mr. DELLIBOVI. I did not review it. We just put together the system that we were going to use in 1989 that was clearly going to be different than what had been done in the past. But I did not look at the previous reports except to see what they had identified and to see if anything had been done about them.

Senator GRAHAM. I do not know how many pages are in this report. [Holding up report.] This was represented to me to be the report, but I assume a substantial amount of effort and expense was invested in this report, and it was the basis upon which a very comforting statement was made to the President. This statement may have contributed to the fact that this problem festered for a longer period than it would have had there been a greater sense of urgency and alarm.

It would seem to be appropriate for the Department to review this report to, if nothing else, see if its standards of selecting contractors to make managerial evaluations is adequate.

You indicated that you have hired another accounting firm to review the section 8 problems. If their work is not acceptable, as apparently you have now indicated that this work was not acceptable, are we facing the prospect of a further delay in effectively dealing with the issue?

Mr. DELLIBOVI. My understanding—and perhaps Mr. Henry can elaborate—is they were already off the case by 1989. So we were not going to have to see any more of their product.

Senator GRAHAM. I was really asking a somewhat different question. Somebody made a judgment to hire this firm to do this report. Apparently the Secretary invested a lot of confidence in this report. As I read it, I think the language in the report is not fully supportive of the paragraphs in the letter to the President, but it is close enough that I do not think they would be indicted for perjury by making the interpretations. I would suggest that this would be an appropriate object lesson of how the Department goes about the process of selecting, monitoring, and then accepting the judgments of its own contractors as a generic matter.

Mr. DELLIBOVI. It clearly would be. But I would also hasten to point out, Senator, that it might be useful before rendering a final judgment on the contractor to obtain any earlier drafts. Sometimes there are earlier versions before the final payment is made by the client. I have noticed in some cases a world of difference between the earlier draft and the final draft.

Senator GRAHAM. I'd be interested in that because that goes back to what Ms. Combs said. Ms. Combs was asked if she felt the President was deceived by this letter. She said the President was not deceived because the President was acting on what the Secretary felt was credible professional evaluation. If, in fact, the report is not credible professional evaluation, but rather the product of massaging and manipulating, then I would return to my question:

Was the President deceived by the December 31, 1987 letter?

Ms. Combs, to what degree, to you knowledge, was this document the unvarnished, unbiased pristine professional evaluation of the circumstances by Watson, Rice & Company? If it was not all of those things, in what ways did it fall short?

Ms. COMBS. Mr. DelliBovi is correct that there were draft versions and management had problems with the draft versions. The conclusions were not significantly different than the draft versions.

What the situation was is, when this contract was let, it was awarded to an 8(a) contractor. OMB had——

Senator GRAHAM. Excuse me. What kind of contractor?

Ms. COMBS. An 8(a) firm, a minority firm.

OMB had instructed the Department to get into compliance with A-127. The previous years, we had reported in our FMFIA that we had not performed the detailed reviews necessary to give an overall statement of assurance. By the time OMB had instructed the Department to do this detailed review, it was a determination made by levels above mine, to perform this review and to award it to an 8(a) firm. And then that process was initiated.

Now, in regard to the second part of your question. During the monitoring of this job, which was on approximately 30 accounting systems, it was a very complicated review. It was done in the process of about a year. There were a lot of questions raised during the review. There were changes made by the firm on the staff. It led to subsequent discussions with the IG on the quality of the review, as you have indicated.

In hindsight, it was probably not the best way to go about the review, but it was the only way, from what I have heard at the time, that management thought that they could proceed to get compliance with what OMB had mandated.

Senator GRAHAM. Was Secretary Pierce aware of these concerns about the report that Watson, Rice & Company was developing?

Ms. COMBS. Sir, I have no idea.

Senator GRAHAM. Senator Mack?

Senator MACK. Let me go back to the question I asked Mr. DelliBovi earlier, and get your feeling.

Do we need to be more specific in law about follow-up? About who has direct responsibility to see that this report that's been put together is, (a), read by somebody, and (b) once it's been read that someone follows up to make sure in fact corrections are put in place. Should we do that?

Ms. COMBS. I believe that Mr. DelliBovi's statement is correct. And that another piece of paper, another reporting mechanism would not necessarily achieve any better results.

Senator MACK. So your answer, basically, is, no. That either OMB or the Congress can either take the initiative or already has the responsibility to take that initiative to follow up on the reports that they've in essence requested?

Ms. COMBS. Yes, sir.

Senator MACK. Do you have any feeling about a greater role for OMB in all of this process?

Mr. DELLIBOVI. I would just begin by pointing out that the chief financial officer will be a career employee to allow some continuity there.

Senator MACK. When do you think, by the way, that will be filled?

Mr. DELLIBOVI. We had hoped it would be filled now. We have to reopen the search because we really want to get the best qualified candidate that we can get. We've received some excellent applications from some very good people, but we believe that we can perhaps find some even better qualified people than the ones who have applied. So we are reopening that position. In the meantime, we've decided to move ahead on the five comptrollers. We are on the verge of selecting the FHA comptroller because that was in the same advertisement as the CFO. The others, the ad closed last week, we have over a thousand applicants, and I am hopeful that we can have this wrapped up by June 15. One of the jobs of the CFO and the comptrollers will be to follow up on audits and these activities.

The OMB part of your question is a tough one. I'd like to point out that the "M" is very small in the Office of Management and Budget. I think, historically, the Director of that office has always gotten most of his attention focused on the budget part of it. That's going to be true for the balance of this century. The Deputy, for management Frank Hodzel, has been very active in this administration already. We've worked with him. He is certainly concerned about that, but it is a big load. And I think, since the creation of the OMB, the management side has not been as much a focus of attention as it probably needs to be.

I believe Director Darman certainly is very management oriented. And his Deputy, for management Frank Hodzel, has been far more active than people who've had that position during the previous administration. I don't even remember their names who were on the management side. So, you know, they seem to be very much more interested but it is an area that OMB needs to monitor and come to its own conclusions.

Senator MACK. Ms. Combs, if I could get back to the discussion that you and Senator Graham were having with respect to the Watson, Rice & Company report.

As I understand it, the report was used as a basis to prepare the letter that was sent to the President, basically telling him not to worry, everything is fine.

Ms. COMBS. The Accounting System Section IV piece, that's correct.

Senator MACK. Did you have the opportunity to review this Watson, Rice & Company report? If you did, did you feel comfortable that what it was saying was adequate and accurate?

Ms. COMBS. Yes, sir, I had an opportunity to review the report. I had questions with the adequacy of the work. I knew that we had initiated or were in the midst of initiating an audit of the non-FHA operations. And that with that combined audit of FHA and the non-FHA activities, that the truth would come out.

Senator MACK. Say that to me again, the last part?

Ms. COMBS. That the truth of whether that was an adequate report of the accounting systems would come out in those financial audits. I had questions about the adequacy. But not performing the work, myself, we could only go on the faith of the work. They were CPA's, and the quality of their work we had hoped would be there, but the financial audits that were done subsequently did indicate serious internal control and accounting principle nonconformances.

So to answer your question, we did wonder about the quality, as did the IG.

Senator MACK. When you say, we, who are you talking about in that particular instance?

Ms. COMBS. Myself and the staff.

Senator MACK. And the IG staff, as well? When were those issues raised? Was it appropriate for you, or if it was appropriate for you to raise your concern, who did you raise that concern with?

Ms. COMBS. The Director of the Office of Finance and Accounting, Shirley Evans.

Senator MACK. What was her response to your concern?

Ms. COMBS. We had an opinion by the auditors, Watson, Rice, and that was satisfactory.

Senator MACK. I get the sense that really what you're saying to me is that the conversation would have gone something like this. You raised a concern, saying I have a feeling here that what's being said really doesn't reflect what's happening out in the field. I can't really prove that because I haven't done the financial work, myself, but my antenna says that there's something wrong with this report. And—what is the individual's name? Shirley?——

Ms. COMBS. Shirley Evans.

Senator MACK. Shirley Evans' response to you, basically, is, look, my concern is getting those things off that report. I've got a document here that nobody's going to read, that in essence, if nobody says anything about it, everything's fine. And, again, essentially my concern is to get these things off the report.

Is that a fair analysis?

Ms. COMBS. Yes, sir.

Shirley Evans, Manager of the Office of Finance and Accounting's position, and I can't speak for her, of course, but management wanted to believe that things weren't disastrous, and this was a report that basically was the way they felt.

Senator **Mack**. Thank you.

Senator **Graham**. I guess that last comment raises the concern about the acceptability of the premise that we're going to depend upon quality well-intended people for our level of assurance that these programs are being properly run. The theory of our form of government is the separation of powers so that you have multiple points of contact in order to check and recheck. That's not the most efficient form of government but it has proven to be one that has protected individual liberties, at least over time. In that context, I continue to be concerned that we don't have a clear process of involving other people to make these kinds of determinations. And I believe that the key to those other people ought to be the Office of Management and Budget. They are the fiscal arm of the President. When the President received this letter December 31, I would think that he would have it reviewed by someone who could give him some independent assurance that it was valid, and, most likely, that assurance would have come from OMB, if OMB was so disposed and so charged with having that responsibility.

Ms. Combs, from your experience inside the agency, do you have any recommendations as to how we can give our children and grandchildren better assurance that this won't happen again?

Ms. **Combs**. I believe that Mr. DelliBovi's statement that this function has been removed from operations, the oversight, the monitoring, and put into an office of management and quality assurance is your best bet. Having managers be responsible for their day to day operations to find all their problems, problems on their watch, report them, fix them, monitor them and say they're fixed is a big chore and, as Mr. DelliBovi said, a lot of that work is not always the kind of work they like to do. They like to do more of the ribbon cutting, as he said, work. So I think that current management moved with that function is an excellent one.

Senator **Graham**. I wanted to comment that, given the managerial quality that was invested, maybe more ribbon cuttings would have been better for this department. [Laughter.]

What concerns me is at that at almost the same time that this letter was being written, we were having representatives of supposedly independent regulatory agencies, the Federal Home Loan Bank Board, sit and testify that we didn't have a problem in the S&L industry. There were adequate funds in the insurance fund so that if we just didn't cause a premature and excessive scare of the public, the Home Loan Bank Board would adequately manage itself out of a temporary inconvenience. That temporary inconvenience has now become a $325 to $500 billion national devil.

Those two instances, what was happening in HUD and what was happening in the S&L industry, makes me feel as if there's something more than just an individual personality defect here. That we've got a systemic problem of too great a concentration of managerial accountability within those persons who were being held accountable.

That's the end of my editorial on that subject. I have just one last question.

Mr. DelliBovi, do you have any comment as to the degree to which the complexity of these programs contributed to the subsequent surfacing of managerial weaknesses? And if that is a problem, do you have any process by which those complexities could be resolved by either the administration or Congress?

Mr. DelliBovi. I would respond in two ways. I think we have too many programs at HUD, number one. And the ones we have are very complicated, probably overly so. As we go through the fix of the individual programs and the review of them, we hope to simplify the handbooks, the rules and the regulations of the procedures. My personal view is that because all of these programs are legislated—the Congress believes each of them is important in a certain way. If I were to be starting the National Housing Program over again—by the way, this is a personal observation; not administration policy—I would draft a program which is formula-based, turns the money out to the states or the localities, very much like the program I managed at the Department of Transportation. The locality gets a certain amount of dollars determined by a formula and then has a series of eligible activities, a menu, if you will, to choose from which activity they want to do. The program would be sort of categorical grant approach with strong State management.

One of the problems that we have in Housing is that most of the States don't have, as you know as a former Governor, as active a role in housing as they do, say, in transportation. Ultimately, it seems to me, that the States, particularly when they have some of their own money involved in these programs, tend to be very good managers. They know what goes on. So if we were starting over again with a housing program, that's the way I would look at it.

In the meantime, we're living with the programs that we have, all of them, and we're trying to fix each one of them that has defects. We do get into the resource issue and the staff issue, because we have so many programs, each one a little bit different. However, I'm not yet able, because we're spending so much time just trying to stop the hemorrhaging and get basic control, to make overall recommendations for the management improvements. When we get these issues of the A-123 with the strong material weaknesses behind us, hopefully, we'll be able to move into that kind of a review of the programs.

If I may say one other thing, in terms of internal weaknesses, we observed internally a tremendous debate last December with our own assistant secretaries as to what was and was not a material weakness. We came up with a rather stringent list. But I want to tell you, there were some internal debates and a tendency of our people to say, well, that's not really a material weakness. We took a pretty hard line. We thought we were losing money, that the taxpayers weren't getting what they were supposed to get, and that that was serious enough to be considered a material weakness.

I point that out just to say that, no matter what you might put in the statute, or what OMB might say, a lot has to do with how the managers look at the process. And you have to understand that when you recognize a material weakness, it's like recognizing a defect in your own child or your own program. And it's tough, personally, for people, particularly who identify strongly with those programs.

Senator GRAHAM. Your last statement just underscores my basic concern about depending upon the good will of individuals. It runs counter to human nature, even the best of humans, to want to search out and publicly disclose your own weaknesses.

Senator MACK. Just one last question. You mentioned in response to an earlier question that the truth would come out. I assume it has, unless there are some other things that we haven't heard of that we need to know.

Ms. COMBS. It has.

Senator MACK. Just a closing comment, Bob. I just want to make my comments with respect to what appears to be an excellent job that Secretary Kemp and Mr. DelliBovi and his staff are doing with respect to internal controls. It is not one, as you say, that gets a lot of people excited on the outside. But I do believe that it is a very important function to guarantee the success of any organization. I'm so pleased to see the willingness on the part of the administration to invest both time and resources into solving these problems, because it's going to make a great deal of difference in the years to come.

Senator GRAHAM. Thank you, Connie, thank you very much.

Before this panel leaves, I understand there is a representative of Watson, Rice in the audience. If the firm would desire to make any written comments, based on what has been said here today relative to the report that was submitted, we'd be pleased to receive the comments and incorporate them as part of the hearing record.

The third panel today consists of representatives from the General Accounting Office.

Mr. Donald Chapin, Assistant Comptroller of the Accounting and Financial Management Division.

Jeff Steinhoff, Director of Financial Management Issues and Audits.

And John Ols, Director of Housing and Community Development Issues.

GAO has been actively monitoring the implementation of FMFIA governmentwide. We look forward to their comments on the application of FMFIA governmentwide, and the specific application of FMFIA to the Department of Housing and Urban Development.

TESTIMONY OF DONALD CHAPIN, ASSISTANT COMPTROLLER, ACCOUNTING AND FINANCIAL MANAGEMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY JEFFREY STEINHOFF, DIRECTOR, FINANCIAL MANAGEMENT ISSUES AND AUDITS, GAO; AND JOHN OLS, JR., DIRECTOR, HOUSING AND COMMUNITY DEVELOPMENT ISSUES, GAO

Mr. CHAPIN. Mr. Chairman, it's a pleasure to be here. With your permission, I'd like to summarize my prepared statement, and have it inserted in the record.

We are pleased to be here today to provide GAO's perspective on the condition of internal control and financial management systems in the Federal Government and actions needed to help eliminate the systems weaknesses that exist throughout the Government.

Unfortunately, we see little overall improvement in the condition of internal controls in the financial management systems throughout the Government since the passage of the Federal Management's Financial Integrity Act, some seven years ago. While, obviously, this was not true in the early days, we believe that the agencies have now identified most of their systems' weaknesses. But they have clearly not done enough to correct these problems, and without corrective action, you get no improvement.

The Government must better manage its systems improvement projects if it's ever to achieve the act's objectives. Emphasis must shift from merely reporting under the act to correcting longstanding weaknesses. Frequently reported agency actions to improve controls have taken the form of systems improvement plans that are not well executed. We also see declarations of intent without any real improvement plan at all. We often see situations where systems have continued to deteriorate or failed to keep pace with change, resulting in new systems weaknesses.

People are an important part of the solution. We need to do something about the Federal pay structure and the turnover in leadership positions; we need a governmentwide training program for accountants and financial management systems personnel. We have to make an investment in people, both in terms of compensation and training, if we're going to have any great success in improving our systems across Government.

Agency top management must be committed to strong internal control and financial management systems, and should be directly involved in ensuring that needed corrective actions are both identified and implemented. We need more interaction where management and auditors come to grips with major agency problems. However, we must remember that it is not an auditor's problem, it's a management problem.

Further, we need the following actions.

Agencies should link the Financial Integrity Act process to the budget process, so that we get some money applied.

Agencies must have top management oversight of the entire FMFIA process. The Secretary and his deputy need to be involved.

Agencies must have processes in place to ensure that completed corrective actions were actually effective.

For its part, OMB has taken some necessary positive steps to show the administration's commitment. It has established a management integrity program that is intended to minimize and prevent fraud and waste in the Federal programs and Federal organizations. Its challenge is to execute on its program.

With respect to the Congress, we have recommended that it hold annual hearings, using Financial Integrity Act reports and plans for corrective actions, and audited agency financial statements as the focal point in its process of holding management of the agencies responsible. In this connection, we see a need for a new approach to Federal financial management to buttress the FIA process.

We have long been strong advocates of legislation which would establish a chief financial officer structure for the Federal Government with counterpart chief financial officers in each of the major agencies. The CFO would develop a long range improvement plan that would deal with system weaknesses and give them the required top level attention within the Government. Our legislative idea would require the annual preparation and audit of agency financial statements, and an annual report to the President and the Congress. And Senator Mack, our idea would also include audit committees as a part of the process.

The annual report that we're advocating would facilitate oversight hearings by Congress. In addition to the audited financial statements, it would include a summary of the Financial Integrity Act reports on agency internal control and financial management systems, and a report summarizing the corrective actions taken. It would be at that point that you might call the Secretary, his deputy and the IG to account for any inaction.

I want to stress that the importance of the preparation of audited financial statements is really an essential part of the solution. It is critical because the audit demonstrates whether an organization's financial systems and personnel are capable of accumulating, analyzing, summarizing, and reporting on the financial condition and operating results. The preparation of financial statements forces the agencies to focus on their systems problems.

Ms. Combs and Mr. DelliBovi correctly summarized the HUD audit situation. We did report, prior to the last audit, that HUD was unauditable. In retrospect, in looking back and thinking about what we've subsequently done at the Air Force, I think we need to pay attention to these unauditable situations more than we have and we need to go the last mile to make sure that our reports very clearly point out the problems. We need to invest the resources to do the kind of job that we did for the Air Force.

Financial statement audits over a period of years of the same agencies show that systems improvements occur over time. The audits serve to monitor the improvement effort, give guidance and, importantly, keep the pressure on. We believe that the preparation of audited financial statements has had a positive impact on the improvement of systems, and correspondingly, a reduction in the Government's exposure to fraud, waste, and abuse in those agencies where we have been able to accomplish financial statement audits and where we have had them for several years.

We'd like to take note of the fact that in December 1989, the Congress passed legislation that created a CFO position in HUD, created comptrollers in each of HUD's major programs, and required annual audited financial statements for each of HUD's major programs. Legislation such as this should have a very positive effect on HUD, and I believe it is urgently needed across the Government.

One final point needs to be stressed. It will take a monetary investment across the Government to improve the financial management systems and deal with the control problems. An investment will also be needed to attract and train adequate personnel. However, I strongly believe that such investment an well made, and that they will ultimately pay for themselves.

For our part, I'd like to report that GAO has implemented a high risk program that focuses on what we think are some of the most vulnerable areas in the Government today. We're focusing on the root causes of serious systems problems in 14 Federal programs.

We will develop approaches to solve the problems associated with these programs. We will be monitoring the agencies' corrective actions and, if necessary, we'll recommend necessary legislative actions to you.

This concludes my summary statement. I'll be happy to answer any questions that you or Senator Mack have, and all of us here at the table are prepared to deal with either the general subject or what we know about the HUD situation.

[Complete prepared statement of Donald H. Chapin follows:]

United States General Accounting Office

GAO

Testimony

For Release
on Delivery
Expected at
2:00 p.m.
Wednesday
April 18,
1990

Federal Internal Control and Financial Management Systems: Major Reform Efforts Are Needed

Statement of
Donald H. Chapin
Assistant Comptroller General
Accounting and Financial Management

Before the
Subcommittee on HUD/Moderate Rehabilitation
Investigation
Committee on Banking, Housing and Urban Affairs
U.S. Senate

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to provide GAO's perspective on the condition of internal control and financial management systems in the federal government and actions needed to help eliminate the system weaknesses that exist throughout the government.

In 1982, the Congress passed the Federal Managers' Financial Integrity Act to strengthen internal control and accounting systems throughout the federal government and reduce fraud, waste, abuse, and mismanagement. At that time, audits of government programs and media reports had identified a large number of serious problems in areas that cut across all agencies and programs. Unfortunately, as discussed in our November 1989 report, Financial Integrity Act: Inadequate Controls Result in Ineffective Federal Programs and Billions in Losses (GAO/AFMD-90-10), 7 years after passage of the act, little has changed. Agency reviews, audits, and newspaper and other media reports continue to identify serious problems that paint the picture of a government unable to manage its programs, protect its assets, or provide taxpayers with the effective and economical services they expect and deserve.

WEAK INTERNAL CONTROL SYSTEMS EXIST THROUGHOUT THE GOVERNMENT

Despite the performance of thousands of internal control evaluations and agency plans to correct the material internal control weaknesses identified, we see little overall improvement in the condition of controls throughout the government since passage of the Financial Integrity Act. Frequently, agency actions to improve controls have taken the form of systems improvement plans that were not well executed. In addition, many systems have continued to deteriorate or failed to keep pace with new demands and additional control weaknesses have appeared. Some long-standing weaknesses, hidden before, have been identified. The Financial Integrity Act has opened our eyes to the problems of government, and we now have identified most of the weaknesses that put the government at high risk to fraud, abuse, waste, and mismanagement. But, we have not done enough to correct the problems that are being reported.

Mr. Chairman, to illustrate a point, I would like to read an excerpt from an article entitled, "The Stench at FHA."

> "FHA has approved marginal or hopeless projects, let promoters milk them. . . and then abandon them. And while FHA has sat dumbly by, other promoters have gone from city to city defaulting on project after project.

> It has permitted still others to default on loans but continue to collect rents for up to five years. . . . In the last 30 months, the GAO has submitted to Congress 11 reports indicting FHA for derelictions ranging from misrepresentations of its income to slovenly neglect of its own foreclosed property."

That quotation is similar to many others written over the past year. However, there is one significant difference. It comes from an April 1966 Reader's Digest article.

In this respect, we have learned little in 24 years. Also, we have accomplished little in the 7 years since the passage of the Financial Integrity Act. We must have a new and larger commitment from all levels of agency management, the Office of Management and Budget (OMB), and the Congress to take appropriate and timely actions to make a real change that will materially reduce the number of serious internal control weaknesses. Commitment means people, new ways of doing things over a sustained period of time, and money. The debacle at the Department of Housing and Urban Development (HUD) has had one positive result; it has refocused needed governmentwide attention on the importance of strengthening the Financial Integrity Act. If we are ever to achieve the act's objectives, however, emphasis must shift from merely reporting under the act to correcting long-standing weaknesses. The situation at HUD has also opened many eyes to the need for additional legislative and administrative actions to strengthen financial management in the federal government. I will mention these actions later in my testimony.

FINANCIAL MANAGEMENT SYSTEMS ARE WEAK AND IMPROVEMENTS ARE SLOW, COSTLY, AND OFTEN INEFFECTIVE

As with internal controls, we see very little progress in the government's efforts to strengthen its financial management systems. Many of the existing systems are weak, outdated, and inefficient, and cannot routinely produce relevant, timely, and comprehensive information. We have old systems that provide a flood of information but little reliable operational and cost data that are essential to monitor program performance, control costs, anticipate overruns, and provide a basis for program and budget planning.

The ever increasing size and complexity of federal programs and overall pressures to reduce the budget deficit will require the availability of adequate and accurate financial information for the successful performance of program management and oversight functions. As the President's fiscal year 1989 Management Report stated, "Once a leader in the early days of automation, the Government's financial systems and operations have eroded to the point that they do not meet generally accepted standards."

The federal government has planned corrective actions and provided billions of dollars for financial management improvement programs. However, these efforts to improve existing systems and develop and acquire new automated systems have and continue to experience massive problems. For example, design flaws, misjudgments in requirements, and poor program management caused the Navy to halt installation of a new automated management information system after spending an estimated $230 million over 9 years to develop the system. Unfortunately, the Navy's experience is not uncommon.

If the government is to strengthen its programs and run them in an efficient and economical manner, it must better manage its system improvement projects.

A STRONG WORK FORCE IS NEEDED TO MEET CURRENT AND FUTURE CHALLENGES

A key factor in the development, implementation, and maintenance of sound federal programs is a strong federal work force. Today, the federal government needs to attract, motivate, and retain committed people at all levels who can develop new ideas and innovative approaches and see them through to effective implementation. Concern is mounting over the impact that both the federal pay structure and the turnover in leadership positions are having on the government's ability to acquire and retain top quality people to carry out its programs.

As experienced employees retire or leave government service and additional staffing needs develop, it is becoming increasingly difficult to hire individuals with the experience and qualifications needed to accomplish the government's mission. The government's general pay scale causes additional problems because it severely restricts the financial incentive programs an agency can implement to reward and retain quality personnel. In addition, we do not really have a governmentwide training program for accountants and financial management systems personnel. We have to make an investment in people, both in terms of compensation and training. Otherwise, I am afraid problems will continue to manifest themselves.

ACTIONS NEEDED TO STRENGTHEN CONTROLS AND ACCOUNTING SYSTEMS

The legislative and executive branches of government must form a partnership, with the common goal of achieving effective and economical federal programs through, in part, the development of sound internal control and financial management systems. We cannot merely think in terms of tomorrow, waiting for something to happen. The poor state of the government's systems demands that we think and act today.

The Problems Should Not Be Left to the Auditor

Agency top management must be committed to strong internal control and financial management systems and should be directly involved in ensuring that needed corrective actions are identified and implemented in a timely manner. With this commitment must also come increased coordination between agency management officials and those in audit organizations such as the Offices of Inspectors General and GAO. For example, last year GAO and the Inspector General and top agency officials at the Department of Transportation worked closely together to identify agency programs needing management attention and actions that could help resolve the existing problems. We need more of this interaction where management and auditors come to grips with major agency problems.

The Administration Must Strengthen the Financial Integrity Act Program

The government's basic internal control and financial management deficiencies are known and, in many instances, have been known for many years, but they remain uncorrected. The identification of deficiencies is an important step, but it is not enough. Agencies must also act effectively to correct them. In the past, no effective mechanism existed to ensure that agencies took the needed corrective actions. In our November 1989 report, we urged, among others, the following actions.

-- Agencies should be required to link the Financial Integrity Act internal control review and reporting process with the budget process. Agencies should identify corrective actions that require incremental funding and major reprogramming in the current budget. This should assist senior decisionmakers in assessing the magnitude of corrective action funding requirements.

-- Agencies should establish senior-level policy committees or take other steps to provide top management oversight of the internal control and reporting process. This should result in better anticipation and consideration of critical issues and more actions to resolve them.

-- Agencies should be encouraged to include a narrative statement in their Financial Integrity Act reports explaining the processes used to ensure that completed corrective actions were effective. The validation process should provide assurance that material weaknesses no longer exist and allow managers to focus their attention and resources on other issues.

The administration is clearly aware that serious problems exist in the federal government. As the Director of the Office of Management and Budget stated in testimony before the Senate Committee on Governmental Affairs,

> "The recently exposed HUD problems are not unique, not merely peculiar to a particular agency under what some describe as absentee management. . . . There are analogous problems in other agencies."

For its part, OMB has established a management integrity program that is intended to minimize and prevent fraud and waste in federal programs and operations. It has assigned responsibility to deputy secretaries and deputy administrators in each agency to ensure the success of this program. Through the reviews and evaluations conducted under this effort, OMB has identified over 100 high risk areas in the 16 largest and many smaller federal agencies and plans oversight and agency reporting on the actions to correct the problems.

Increased Congressional Oversight and Financial Management Legislation Needed

The Congress can also significantly contribute to effective corrective action through its oversight role. We have recommended that its authorizing, appropriations, and oversight committees hold annual hearings using Financial Integrity Act reports, plans for corrective actions, and audited agency financial statements as the focal point in the process of reviewing agency actions to correct internal control and accounting system weaknesses. Such hearings could help assure the Congress that corrective measures are implemented and that they are effective.

In this connection, the widespread occurrence and significant dollar and programmatic impact of federal accounting system weaknesses, in particular, highlight the need for a new approach to federal financial management. We have long been a strong advocate of legislation which would

-- establish a chief financial officer (CFO) structure for the federal government, with counterpart chief financial officers in each of the major agencies and

-- require the annual preparation and audit of agency financial statements and a report to the President and the Congress.

The legislatively established chief financial officer would develop a long-range governmentwide financial management plan.

The supporting structure would provide direction and continuity when leadership changes occur in the administration as well as at the agency level. Establishing a CFO structure would help give financial management the prominence, permanence, and continuity necessary to achieve reform and enable the government to better manage its financial affairs, save billions of dollars, and help restore the accountability of managers and the credibility of government.

The report to the President and the Congress would include (1) the annual financial statements, (2) the audit report on those financial statements, (3) a summary of the Financial Integrity Act reports on the systems of internal control, (4) a report summarizing the corrective actions taken with respect to the material weaknesses identified in the Financial Integrity Act reports, and (5) other information the agency head considers appropriate to fully inform the President and the Congress concerning the agency's financial management.

The preparation of audited financial statements is an essential part of the solution. It is critical because it demonstrates whether an organization's financial systems and personnel are capable of accumulating, analyzing, summarizing, and reporting on its financial condition and operating results. Preparing the statements also forces agencies to acknowledge their systems problems.

For years, the federal government has insisted that publicly traded companies, as well as state and local governments, submit their financial statements to the scrutiny of an independent audit. The federal government should do no less. Annual audits promote discipline in the recording and processing of data simply because people know that the information is subject to review. Further, the improved quality of the financial information that can be obtained when accurate financial statements can be prepared enables agencies to place greater reliance upon this information in making decisions and monitoring program implementation. Hopefully, until legislation is passed, the administration will continue to work with GAO to expand the number of agencies and departments preparing financial statements and submitting them for audit.

Our recent financial audit of the Federal Housing Administration (FHA) is a good example of why accurate and audited financial statements are needed.* FHA's financial reports, which identified losses of $858 million for fiscal year 1988, were misleading in the extreme. In fact, after making the required adjustments identified during the audit, the losses were $4.2 billion, or almost five times greater than management's best information showed them to be.

*(For additional information, see GAO 9/13/89 testimony attached.)

Our initial financial audits throughout government have revealed problems with financial systems. Frequently they are so severe that information needed to manage agency operations, as well as to prepare agency financial statements, is unreliable and seriously deficient. Generally, these problems are more serious and deep-seated than either we or agency managers realized before our audits. Subsequent audits of the same agencies show improvements, but also show that systems cannot be fixed overnight. Many times, it takes 2 or 3 years to cure some of these situations. Subsequent audits serve to monitor the improvement effort, give guidance, and keep the pressure on. We believe that the preparation of audited financial statements has had a major positive impact on the improvement of systems and, correspondingly, the reduction in the government's exposure to fraud, waste, and abuse.

HUD's Leadership Has Recognized the Department's Financial Management Needs

For its part, HUD's leadership has recognized the need for central direction and qualified leadership in the financial management of its programs. HUD reported in its 1989 Financial Integrity Act report, and the Secretary has publicly announced, that in order to bring financial integrity to agency programs, it

-- had established a special task force on Program Financial

Management headed by an under secretary to strengthen financial management in 26 program activities;

-- would soon appoint a chief financial officer for the Department who will be responsible for overhauling accounting and financial reporting policies, ensuring the development and operation of a sound financial management system, and establishing comptrollers for the major HUD activities such as FHA; and

-- would prepare annual financial statements and have them audited by an independent accounting firm beginning with fiscal year 1990.

Further, in December 1989, the Congress passed legislation that, among other things, created a CFO position in HUD, created comptrollers in each of HUD's major programs, and required annual audited financial statements for each of HUD's major programs. Legislation such as this should have a very positive effect on HUD and is needed across the government.

Improvements Will Require Monetary Investment

One final point needs to be stressed: it will take a substantial monetary investment across the government to acquire the financial management systems that are needed and to attract and train personnel to operate them. In an era of severe budget restraint, there may be a temptation to take shortcuts to hold down these costs. I strongly believe, however, that new systems will ultimately pay for themselves. The payoff will come not only in terms of better efficiency and prevention of loss from fraud, waste, abuse, and mismanagement, but also in greater confidence in the integrity of government operations and program decisions.

GAO'S "HIGH RISK" PROGRAM

Are there other HUDs today? Unfortunately, I believe there are. To what extent, we are not quite sure, but there are unexploded bombs out there that need to be defused before they explode. We have developed a "high risk" program that focuses on what we think are some of the more vulnerable areas in the government today. Under the program, we

- -- have identified 14 major areas (see attachment I) we believe to be highly vulnerable;
- -- are focusing, in conjunction with efforts of agency management and the inspectors general, on the root causes of serious long-standing weaknesses to develop approaches to solve the problems associated with these

programs;

-- are monitoring agency corrective actions and reporting the results to the appropriate congressional committees; and

-- will recommend legislative actions necessary to ensure that corrective measures are implemented.

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Mr. Chairman, the active involvement of the Congress and hearings such as this one, directed at improving HUD's programs, are critical to correcting the internal control and financial management systems problems facing the government today. Without strong congressional oversight, the changes needed to safeguard federal assets and ensure the efficient and economical operation of federal programs will not occur. I look forward to working with you and other interested members of the Congress to achieve the internal control and financial management improvement initiatives discussed today.

This concludes my formal statement. I will be happy to answer any questions you or members of the Subcommittee may have.

INITIAL AREAS SELECTED FOR SPECIAL GAO AUDIT OR REVIEW

Resolution Trust Corporation - The management and disposal of approximately $200 to $300 billion of thrift assets will pose unprecedented management problems. A sale of this magnitude is unparalleled in history. The desire and potential to acquire these assets at bargain basement prices will make this area highly susceptible to fraud, waste, and abuse.

Internal Revenue Service Receivables - The existence of accounts receivable in excess of $60 billion which have grown about 300 percent since 1980 places this issue in the significant potential loss area. In light of the budget deficit, the potential for reducing or stabilizing the growth rate offers major dollar savings and thus warrants special review and oversight.

Management of Seized and Forfeited Assets - This issue has been characterized by mismanagement which has been the subject of considerable press attention. Responsibility for managing the program rests with the Customs Service and the U.S. Marshall's Service. Both organizations have been identified by their respective departments as having significant internal control weaknesses. Improvements in the management and control of this program will lend support to the war on drugs and increase public and congressional confidence in the program.

Medicare Questionable Claims - The tens of billions of program dollars coupled with considerable potential for fraud and abuse indicates a high potential for financial savings from our efforts. Identified payments of $527 million by Medicare in 1985 that should have been paid by private insurance carriers illustrate the magnitude of potential savings.

ERISA/PBGC - The Department of Labor's and IRS's enforcement of ERISA has a significant impact on ensuring that employee benefit plans are free of mismanagement, fraud and abuse that place plan assets at risk and threaten the benefits of plan participants. The adequacy of their oversight has a direct financial effect on the potential for loss by the Pension Benefit Guaranty Corporation, an organization that has been unauditable in the past. The underfunding of approximately 20 percent of the plans insured by PBGC is estimated at $20 to $30 billion but is concentrated in particular industries where downturns could have a significant impact. The potential $2.2 billion impact on the fund of one company's bankruptcy, LTV Corporation, demonstrates the vulnerability of this program, and thus the taxpayers' exposure to potential losses.

Guaranteed Student Loans - The large number of banks, state agencies, and schools participating in guaranteed student loan programs coupled with poor systems to protect the federal government's financial interest creates the potential for significant abuses and losses. A high proportion of defaults and publicized abuse by certain proprietary schools suggest the need for improved program controls.

State Department Real Property Management Overseas - There is adequate evidence of waste, mismanagement, and poor controls in this area as illustrated by the construction fiasco at the U.S. Embassy in Moscow. There is high potential for financial savings through better property management. Corrective action over the years has been minimal, but recently State has begun to show an interest in addressing these issues.

DOD Inventory Management Systems - Department of Defense inventories exceed $100 billion of which unneeded or excess inventory exceeds $30 billion. The excess inventory along with numerous other indicators (e.g., the failure to cancel orders where excess stock is already on hand) reflect financial management problems. Management incentives focus on filling orders and obligating funds. There is no corresponding focus on reducing costs or controlling or securing stock, i.e., economy and efficiency. The current pressure to reduce the DOD budget in response to recent world events provides additional incentives to make major improvements in the supply system.

DOD Major Systems Acquisition - The total estimated cost of major systems currently being developed or produced exceeds $900 billion. Following established management controls to deliver capable and supportable weapons to the user when and where needed, and at reasonable cost, has been the exception rather than the rule. As a result, DOD continually buys higher cost systems which substantially exceed original estimates, are delivered much later than originally scheduled, and do not meet the capabilities advertised. GAO will review the effectiveness of management initiatives to address these long-term problems and their means of achieving savings.

NASA Contract Management - NASA will spend $11 billion in 1990 on contracts and has a very decentralized contract administration process. In this environment, there is considerable potential for mismanagement, fraud, and abuse. The potential for large savings exists if better contract controls and oversight can be achieved.

Farmers Home Administration Loan Programs - FmHA has made billions of dollars of credit available to the nation's farmers. Delinquent farm loan borrowers held $11.1 billion, or 48 percent, of the agency's $23.3 billion in outstanding loans as of September 30, 1989. FmHA is responsible for protecting the government's interest, as well as helping farmers who cannot get help elsewhere. Recognizing congressional concern to reduce the deficit, any potential for controlling loan losses warrants added review and oversight.

Superfund Enforcement and Contractor Oversight - The Congress has authorized $10 billion for the Superfund program but estimates of federal funds needed to complete the cleanups are many times that amount. To avoid wasting federal resources, the Environmental Protection Agency (EPA) needs to (1) ensure that parties who contaminate sites pay their fair share of the clean-up costs and (2) effectively manage clean-up contractors who get over 75 percent of Superfund's outlays. GAO will explore cost and conflict of interest control and whether EPA uses its full authority to compel private party cleanup.

Urban Mass Transportation Administration Grants - UMTA currently manages active grants totaling $30 billion with over $3 billion in new grants each year. The number of staff available to UMTA for project oversight is limited. Based on recent GAO survey work, increased oversight of the grant application review process and adherence to grant provisions is needed. The criteria for deciding what projects get funded and in what amounts is limited, and, in some cases, projects are funded at the sole discretion of the Administrator.

Department of Energy Contractor Oversight - DOE relies on contractors and consultants for most of the work needed to fulfill its mission. For example, DOE obligated about $15 billion for procurement in 1988. The Department has had a history of inadequate contractor oversight and bonus awards to contractors in situations that would appear to be highly questionable. While this may be due in part to lack of expertise or inadequate staffing, it also may be due to DOE's philosophy of "least interference" with its operating contractors. GAO will examine DOE's potential for improvements in control, accountability, and efficiency.

United States General Accounting Office

GAO

Testimony

For Release
on Delivery
Expected at
9:30 a.m.
Wednesday,
September 13,
1989

GAO Audits of Accounting and Financial Management Systems at the Federal Housing Administration

Statement of
Dennis J. Duquette
Director, Agency Financial Audits

Before the
Subcommittee on Housing and Community Development
Committee on Banking, Finance and Urban Affairs
House of Representatives

GAO Form 160 (12/87)

Mr. Chairman and Members of the Committee:

We are pleased to appear here today to discuss GAO's efforts to conduct financial statement audits at the Federal Housing Administration (FHA) and the financial management problems at FHA that we have previously reported.

FHA and the Department of Housing and Urban Development (HUD) have received a great deal of publicity recently regarding various accounting and financial management problems. We have reported many of these types of problems for years. In addition, HUD's Federal Managers' Financial Integrity Act reports have consistently disclosed material weaknesses in FHA and HUD internal controls. FHA's serious accounting and financial management problems have been well documented in all of these reports, as well as in HUD Inspector General reports. Many of the problems have been long-standing. We have found that many of the deficiencies cited in earlier reports continue to be found in our more recent reviews.

Correction of FHA's problems will require multiyear solutions and a long-term management commitment. Strong action is needed by top management to address the very serious problems that continue to affect FHA. An action plan with milestones needs to be developed and implemented with independent monitoring and audit, particularly annual financial statement audits, to ensure that progress is achieved and any obstacles are identified so that early resolution can be reached.

Before I get into the details of our various financial statement and program reviews, let me spend a few minutes discussing some background related to FHA.

BACKGROUND

FHA was established in 1934 under authority granted to the President by the National Housing Act (Public Law 73-479). In 1948, FHA became a wholly owned government corporation subject to the Government Corporation Control Act, as amended. FHA and its functions were transferred to HUD in 1965. After the transfer, FHA no longer had separate staff or facilities; its operations have been conducted, along with other housing activities, by HUD organizations.

The basic purpose of FHA programs is to encourage improvements in housing standards and conditions, provide an adequate home financing system through mortgage insurance, and exert a stabilizing influence on the mortgage market. To carry out this purpose, the Secretary of HUD administers FHA through four separate funds for its various mortgage insurance programs--the Mutual Mortgage Insurance Fund, the Cooperative Management Housing Insurance Fund, the General Insurance Fund, and the

Special Risk Insurance Fund. As of September 30, 1987, FHA had $277 billion of insurance-in-force and net government equity of $1.2 billion. The Mutual Mortgage Insurance Fund, which is intended to be self-financing, is the largest fund with $205 billion of insurance-in-force and government equity of $3.4 billion as of September 30, 1987.

EFFORTS TO CONDUCT FINANCIAL STATEMENT AUDITS

FHA became subject to annual audits by the Comptroller General under the Government Corporation Control Act in 1948. In 1974, the Government Corporation Control Act was amended, and the requirement for an annual audit was changed to require that an audit be made at least once every 3 years.

Our fiscal year 1974 financial statement audit resulted in our issuance of an unqualified opinion indicating that, in our opinion, the financial statements presented fairly, in all material respects, FHA's financial position and results of operations in conformity with generally accepted accounting principles and with applicable federal laws. This was the last unqualified opinion issued on FHA's financial statements.

In 1975, serious problems with FHA's financial management operations began to surface. From 1975 until recently, we were not able to conduct full financial statement audits of FHA because of very serious accounting and internal control deficiencies which prevented FHA from producing accurate financial statements. These deficiencies included unrecorded transactions, lack of detailed supporting records, and lack of reconciliation of several key accounts to detailed supporting records. For fiscal years 1975, 1976, and 1978, we issued disclaimers of opinion because we were not able to express an opinion on the fairness of FHA's financial statements.

For fiscal year 1981, due to continuing accounting and financial reporting deficiencies, we worked extensively with FHA to assemble a set of financial statements in accordance with generally accepted accounting principles. We issued a report to the Congress (GAO/AFMD-83-66, June 10, 1983), which included FHA's unaudited financial statements. We did not conduct an audit of the accounts because the effort to assemble the statements required a great deal of time and the additional time that would have been needed to gather evidence to support an opinion would have extended this audit into fiscal year 1984, the year of our next required audit. Also, the financial data would have been 3 years old.

In May 1984, we began our fiscal year 1984 financial statement audit, but terminated our efforts after several months because of the continuing serious accounting and financial reporting problems. We met with the HUD Assistant Secretary for

Administration and discussed the issues that needed to be addressed before we could conduct a successful audit. These issues included FHA's responsibility to

- -- improve internal controls over the general ledger system to ensure it would generate reliable data,
- -- test new computer systems before implementation to ensure proper operation, and
- -- reconcile key financial transactions and account balances to the supporting detailed records.

The Assistant Secretary responded to our discussion in a letter dated December 6, 1984, and stated that she was in overall agreement with us and that she had already begun to address a number of the issues that we had presented. To help her resolve these issues, the Assistant Secretary hired several accountants from GAO who were familiar with FHA's financial problems.

To help us fulfill our audit responsibility for fiscal year 1987, we contracted with the independent certified public accounting firm of Price Waterhouse. Although improvements had been made to the accounting and financial systems, the magnitude of accounting and reporting problems still present made it impractical to audit FHA's consolidated statements of operations and changes in financial position for fiscal year 1987. Therefore, Price Waterhouse's 1987 work focused on auditing FHA's statement of financial position as of September 30, 1987, so as to establish a baseline for a 1988 audit. For fiscal year 1988, Price Waterhouse will provide an opinion on a full set of audited financial statements, as well as reports on internal accounting controls and compliance with laws and regulations.

After FHA agreed to numerous adjustments totaling some $1.9 billion, Price Waterhouse expressed an unqualified opinion on the fairness of FHA's consolidated statement of financial position as of September 30, 1987. In our opinion, and consistent with the opinion of Price Waterhouse, FHA's statement of financial position was fairly presented. Our report to the Congress incorporated Price Waterhouse's report (GAO/AFMD-89-3, May 12, 1989).

The fiscal year 1988 audit is well underway and is expected to be completed shortly. Our report will be issued soon thereafter. In addition to the opinion on the financial statements and reports on FHA's internal accounting controls and compliance with laws and regulations, Price Waterhouse is developing a separate report on those items identified during its audits which it believes management needs to correct. When the Price Waterhouse audit work is complete, we would welcome the opportunity to discuss the results of our work on the 1988 audit results.

REVIEWS OF FINANCIAL OPERATIONS REVEALED SERIOUS DEFICIENCIES

In addition to our financial audit work at FHA, we have also performed reviews of various FHA programs and over the years have issued many reports that describe serious deficiencies in FHA's operations. The reports identified a wide range of financial management problems including internal control weaknesses, accounting system deficiencies, and management inattention. Many of the problems noted in our more recent reports are the same problems cited in earlier reports. Attachment I to this statement includes a list of these reports. I would like to highlight for you the problems we found during a few of our major reviews in the last several years.

-- In 1984, based on an overall general management review of HUD, we reported (GAO/RCED-84-9, January 10, 1984) that HUD's management information systems do not provide timely and accurate data necessary to establish accountability for, and control over, housing and urban development programs. One of these key systems involved the process for underwriting FHA's single-family mortgage insurance. We reported that, although HUD spends millions each year to gather data, much of the data cannot be relied upon for controlling and monitoring programs, and information needed by managers is not accurate, timely, or readily available.

In addition to program functions, we found that accounting activities would benefit from better systems. Although HUD started automating its accounting systems in the 1950s, these systems are not fully automated and extensive manual effort is needed for accounting functions. Historically, these functions have received limited top-management emphasis and lower priority in systems development. The result has been, as stated in our report, that systems do not include the necessary internal controls to adequately protect against fraud, waste, and mismanagement; do not comply with GAO's principles and standards; and do not provide management with timely and accurate financial data needed for oversight, program implementation, and budgetary analysis.

-- In May 1985, we reported (GAO/RCED-85-4, May 13, 1985) that HUD needed to strengthen its internal controls over procedures for approving insurance on single-family home loans. We found that HUD relies on lenders to obtain and verify information needed to determine the financial capacity of borrowers to repay and does not independently verify the credit information submitted by the lender, like other properly managed mortgage insurance programs. Because HUD's single-family loan insurance program protects lenders from the risk that they will not be repaid, making an FHA-insured home loan is virtually risk free for the lender. Because of the weaknesses we reported in HUD's procedures, in a much-publicized case, a single lender was able to make many loans to home buyers who had no credit history and, in some cases, information regarding the identity of the borrowers and their financial qualifications was misleading.

-- In 1985 (GAO/RCED-86-22, October 8, 1985), we reviewed HUD's second-year implementation of the Federal Managers' Financial Integrity Act of 1982 (FMFIA). The act was intended to help reduce fraud, waste, and abuse in federal government operations by requiring agencies to assess and report annually on the adequacy of their internal controls and accounting systems. Our review found that HUD needed to improve its process of identifying, evaluating, and correcting internal control problems. Also, our review noted that HUD's systems were not in conformance with GAO's standards and requirements.

-- In June 1986, in reporting internal control actions taken on the basis of recommendations made by the HUD Secretary's Single Family Task Force and in our May 1985 report, we found that controls over monitoring loan defaults and verifying loan data submitted to HUD by lenders still needed to be improved (GAO/RCED-86-172, June 3, 1986).

-- In September 1987, we reported (GAO/RCED-87-165, September 30, 1987) on the continuing weaknesses in FHA's home appraisal program. HUD's 1983 FMFIA report identified material weaknesses in its method of selecting and reviewing home appraisals, which opened the program to fraud and abuse, and contributed to FHA's mounting losses. Appraisals were inappropriately selected for review, reviews were inadequate, appraisers were used as reviewers, and computer controls over appraiser assignments were routinely overridden.

FHA has a mortgage monitoring system, and we have been reviewing FHA's management controls to ensure they are being implemented as intended to eliminate fraud, waste, and abuse. The early results of our review of the monitoring system show the following.

-- FHA's system is not adequate for monitoring regional and field offices, lenders, fee appraisers, and counseling agencies. The system does not include all necessary monitoring to ensure that lender quality control plans are adequate, sanctions are imposed for poor performance, and appropriate management uses are made of the results of monitoring.

-- FHA does not have a complete and reliable system for tracking audit findings and recommendations.

In addition to identifying breakdowns in FHA's management controls, I would also like to point out that our work has indicated that there are opportunities to reduce costs by improving program policies and procedures. For example, in April 1988, we reported that in fiscal year 1987 FHA lost $1.2 billion on the sale of properties acquired because of loan defaults, and we identified changes to improve controls over the foreclosure process to reduce costs. For example, we pointed out that FHA should encourage lenders to obtain property deeds from delinquent borrowers willing to offer deeds in lieu of undergoing prolonged foreclosure proceedings which are costly to FHA. Based on our observations, HUD has implemented this and several other procedural changes that, if properly implemented, could result in multimillion dollar savings to the government.

CONCLUSIONS

I have mentioned a few examples of the many reports we have issued over the years describing various deficiencies in many of FHA's programs. FHA's accounting and financial management problems have been long-standing and well documented. Correction of these problems will require multiyear solutions and a long-term commitment by top management.

Although there are no easy fixes to the problems in federal financial management, the development of accurate and reliable financial statements is a very important step in addressing the accountability for assets, recognition of liabilities, and accounting for operations. We have often stated in testimony before the Congress that annual audits, including reviews of internal accounting controls and compliance with laws and regulations, would focus attention on an agency's major problems. To improve accountability, we strongly believe that top management needs to develop an action plan with milestones addressing the improvements needed in FHA/HUD's accounting and financial management systems. The plan should also provide for the accountability and discipline of financial statements and the performance of annual financial audits. Agency management and the Congress can monitor HUD's progress through an annual review of the independent auditor's opinion, reports on internal accounting controls and compliance with laws and regulations, and management's report required by the Federal Managers' Financial Integrity Act.

This concludes my statement, Mr. Chairman. We will be pleased to respond to any questions you or members of the Committee may have.

LIST OF SELECTED GAO REPORTS RELATING TO FHA--1975-1988

Housing Programs: HUD Policies to Minimize Costs in Acquiring Foreclosed Properties (GAO/RCED-88-141BR, April 18, 1988)

Weaknesses in HUD's Single Family Housing Appraisal Program (GAO/RCED-87-165, September 30, 1987)

Housing Programs: Agency Actions to Discourage Single Family Mortgage Insurance Fraud (GAO/RCED-86-172BR, June 3, 1986)

Debt Collection: Billions Are Owed While Collection and Accounting Problems Are Unresolved (GAO/AFMD-86-39, May 23, 1986)

HUD's Second-Year Implementation of the Federal Managers' Financial Integrity Act (GAO/RCED-86-22, October 8, 1985)

Stronger Internal Controls Over HUD Single-Family Mortgage Insurance Programs Would Discourage Fraud (GAO/RCED-85-4, May 13, 1985)

Increasing HUD Effectiveness Through Improved Management (GAO/RCED-84-9, January 10, 1984)

Problems Continue in Accounting for and Servicing HUD-Held Multifamily Mortgages (GAO/AFMD-82-18, August 18, 1982)

Defaulted Title I Home Improvement Loans--Highly Vulnerable to Fraud, Waste, and Abuse (GAO/AFMD-82-14, December 7, 1981)

HUD Should Make Immediate Changes in Accounting for Secretary-Held Multifamily Mortgages (FGMSD-80-43, May 16, 1980)

Housing and Urban Development's Efforts to Improve Its Accounting System for Mortgage Insurance Premiums (FGMSD-80-27, March 19, 1980)

Delays in Implementing the Department of Housing and Urban Development's Accounting System for its Mortgage Insurance Program (FGMSD-80-37, March 4, 1980)

Weaknesses in Servicing and Accounting for Home Mortgages Held by HUD (FGMSD-79-41, August 16, 1979)

Action Being Taken to Correct Weaknesses in the Rehabilitation Loan Program (FGMSD-79-14, March 14, 1979)

Weaknesses in the Department of Housing and Urban Development's Financial Management System (FGMSD-77-75, December 28, 1977)

Millions of Dollars in Delinquent Mortgage Insurance Premiums Should Be Collected by the Department of Housing and Urban Development (FGMSD-77-33, September 8, 1977)

Second Interim Report on Review of HUD's Accounting System for Billing and Collection of Federal Housing Administration Mortgage Insurance Premiums From Mortgagees (FGMSD-77-7, December 13, 1976)

Action Being Taken to Correct Weaknesses in the System of Paying Taxes on Acquired Residential Properties (FGMSD-76-24, November 26, 1975)

Need for Improvements in the Automated Payroll System of the Department of Housing and Urban Development (FGMSD-75-31, June 18, 1975)

Senator GRAHAM. Mr. Steinhoff, Mr. Ols, do you have any further comments?

Mr. STEINHOFF. Not at this time.

Mr. OLS. No.

Senator GRAHAM. Did you say, Mr. Chapin, that you considered HUD to be an unauditable agency given the conditions of its systems at the end of the 1980's?

Mr. CHAPIN. Yes.

Senator GRAHAM. Have you had an opportunity to review the report that was done by Watson, Rice & Company?

Mr. CHAPIN. No, sir. I don't think we have any knowledge of that report.

Senator GRAHAM. It was stated in the previous panel that it was assumed, largely based upon that report, that the Secretary had felt it appropriate to send a letter to the President and Congress on December 31, 1987, which contained the statement to the effect of "we completed a review of our accounting systems in use during fiscal year 1987, and we can now report substantial compliance with OMB and General Accounting Office Standards."

Is it your statement that this representation to the President and Congress was not accurate?

Mr. CHAPIN. I don't understand how you can have an unauditable agency and be able to make that statement.

Mr. STEINHOFF. In the audit we just finished, we were able to complete an audit of FHA for the first time for 1988, and we found the losses were much higher than were reported. Instead of $858 million, they were $4.2 billion.

Senator GRAHAM. Excuse me, would you repeat those numbers?

Mr. STEINHOFF. Instead of an $858 million loss——

Senator GRAHAM. In which program, the FHA?

Mr. STEINHOFF. It was $4.2 billion. That's what the audit showed. But that was the first time we were able to perform an audit. In prior years, we went in, looked at the books, turned our backs, and said, you can't audit this.

Mr. CHAPIN. It's our experience that, when you have an unauditable situation, you must have very major Financial Integrity Act problems.

Senator GRAHAM. When was the first time that you concluded that HUD was an unauditable agency?

Mr. STEINHOFF. We'd have to provide you an exact year for the record, but I think it goes back to the 1970's. We were required by law, under the Corporation Control Act, to perform that audit every 3 years. There isn't much interest when you go in and you say, it's not auditable. That doesn't really ring home to people. When you go in and you audit it and say, well, you lost four times as much money, five times as much money, that hits home. So it wasn't until we did an audit that people were really more interested in it.

Senator GRAHAM. Within the department, to whom did you report your assessment that the agency was not subject to audit?

Mr. STEINHOFF. I would have to check in each year, but I presume we reported to the head. This isn't the only department where we'd have this problem. We are beginning an audit right now of the Pension Benefit Guarantee Corporation. We're talking about an activity that's got $800 billion of pension funds that they're protecting, and in the past, it's been unauditable. And in these cases, we would tell top management that we can't perform the audit. We are now, under our high risk program, attempting to perform an audit.

Mr. CHAPIN. The difference in our approach, now, in looking at these situations, is that we will not just report that the agency is unauditable; we will continue to invest resources sufficiently so that the problems can be clearly identified, as they were in the Air Force audit. So it's spread before all who have oversight, the true facts of the situation. It's not enough, I think you know, saying something is unauditable. That should ring a lot of bells but frequently doesn't. When you spell out what that means or can mean, it becomes a lot more meaningful.

Senator GRAHAM. But I hear you saying that unless you can perform an audit that is meaningful and complies with acceptable standards, you can't get to the point of reporting numbers which will generate the public outcry necessary to adequate the accounting systems in the first place.

Mr. CHAPIN. As you will recall, when we looked at the Air Force, we were unable to certify any of those numbers. Over 70 percent of the assets were unauditable. We found a way to identify the problems to such a degree that it was apparent that there was a very serious problem. And that's basically how we intend to deal with this situation. So in the case of the Pension Benefit Guarantee Corporation, we don't know whether that corporation is auditable or not, but it will be clear when we finish our work, what the true situation is if we go far enough and spell it out.

Senator GRAHAM. Senator Mack?

Senator MACK. I just want to follow up on that line, and I apologize, maybe after a couple of hours, my mind begins to wander. I just want to be sure I understood what you said.

Since 1974, I think you've been saying, the situation from the standpoint of financial data being available in a meaningful sense, that there is just no way to audit this operation. And since 1974, we've gone through several administrations, obviously, and we've gone through numbers of Congresses. And, in essence, nobody has responded; nobody has even reacted?

Mr. CHAPIN. That's right.

Senator MACK. Which I guess kind of gets back to the theme I feel I have been touching on all throughout these last couple of hours. That is, if there is not in place a systematic approach that fundamentally evaluates audit statements that you all make with respect to the financial condition of the various agencies, unless there is a formal, almost scheduled process, we will continue to see this happen. And only at such a time that the crisis is known by everyone, will there be attention focused on the need to solve that problem.

Mr. CHAPIN. I agree with that general statement, Senator. There are lots of ways you can get there, but I agree with the general statement.

Senator MACK. And I do apologize. In your summation, you were stating an approach that you thought we ought to follow. Could you just kind of, step by step, identify in abbreviated form, what you think we ought to be doing?

Mr. CHAPIN. Congressional oversight, the authorizing committees need to hold hearings on the annual report that includes financial statements of the agencies, a summary of the FIA problems, and a statement by the agency on what actions that it has taken or not taken to identify and deal with the problems. You have to talk to the Secretary and the inspector general. From the Congress' standpoint, that would be a very effective way to go about this.

There are other things that could be done that would be very helpful also.

Senator MACK. Two questions, then. (a) What would those other things be, and (b) who would make that report available to the Congress? Would it be the process that we've been talking about here?

Mr. CHAPIN. This would be part of the financial management legislation which we have been proposing.

Senator MACK. The concept of the chief financial officer?

Mr. CHAPIN. The chief financial officer concept. That's another way you would have more assurance that these problems were being attended to. The chief financial officer, if properly placed at the top of the Government, would not have agency bias. He'd be able to look at this thing and work at it from the point of view of overall Government needs. It's something OMB is attempting to do now with the limited resources that they have, but if we had it placed right in Government the independence of that role would be, I think, very effective in bringing to light these kinds of situations.

Senator MACK. You mentioned in there that OMB has attempted, from time to time, I guess, to expand their responsibilities in the areas of management, but don't have the resources. Establishing a chief financial officer is going to require resources, as well. I assume the argument can be made, if you're going to have to have resources available, why not give them to an organization that's already in place. Do you have a problem with that from the standpoint of the independence?

Mr. CHAPIN. No, not from the point of view of independence. I think OMB or an independent chief financial officer or somebody at the Treasury can all perform that role. But, it should not be placed in the agencies. You have seen how this thing at HUD has unfolded this afternoon. We were all listening to how that happened.

Senator MACK. Give me your reactions to what you heard as how it all unfolded, just then.

Mr. CHAPIN. Just generally speaking, what I heard is that there was a lot of discussion within the agency, a lot of sensitivity about the surfacing problem and the people at the bottom were trying to deal with the situation and were unable to get it to the top. If they did, the top really didn't do anything with it. It's very hard, as one of you said, it's very hard to look at your own problems and own up to them and say, this is the problem, this is a serious problem and it's my responsibility to deal with it. It's very hard to do that.

Mr. STEINHOFF. Oftentimes, too, on this, we've found that the preoccupation got down to the report itself because the law did require the heads of the departments to put their name on the dotted line. And a lot of the focus was placed on having a process in place to have some type of rationale for putting that name on the bottom. The focus was on the report, itself, or papering over the problems, and not as much on correction. That was wrong. The focus should have been on, let's correct what's wrong.

Mr. CHAPIN. We've had an FIA act for 7 years and for reasons that are not clear to me, it's obvious to me that the FIA act called for fixing the problems—for some reason or other, the agencies were caught up in the reporting part of it, to the extent that most of them were willing to recognize the problems and report them, but really didn't deal with them.

Senator MACK. I picked that up in your comments. You talked about reporting and correcting. And there are two really very specific aspects of what we're talking about here.

Any other suggestions that you might have that would help in the area of correcting, other than the concept of the chief financial officer?

Mr. CHAPIN. That concept, though, is broader than just having a chief financial officer. If we had such an individual, with the right resources, we could do the systems planning at the right levels of Government so that we could encourage and help the agencies deal with their problems. System talent is very scarce; it's scarce in private industry as well. And for an agency to acquire top level systems people with the salary problems and so on, is very difficult. So where we believe we should focus is on providing technical assistance to the agencies from the chief financial officer and his staff. It would be an effective way to get prompt action and some effective action. We're spending billions of dollars on systems that don't work. And we think that one of the reasons they don't work is the right people aren't planning them. So that would be, that whole CFO structure would be, in fact, very effective.

I also mentioned, briefly, that we believe that the agencies should have audit committees to provide an external perspective so that when the Secretary wants to review the FIA report, that he has a group of people that can sit down with him and work on that report and say, what does this mean. One of the things that we have observed——

Senator MACK. Let me just interrupt you for a second.

Who would make up that audit committee?

Mr. CHAPIN. People outside of the agency.

Senator MACK. Professionals outside of the agency?

Mr. CHAPIN. Professionals or people at other agencies. It can be Government people. But, again, it gives you another perspective. And you know how that works in industry. It's helpful to have a good audit committee to see the real problems. One of the difficulties that we have had with all of this FIA reporting is we get symptoms reported, we get problems identified, but root causes, the real reason why things are going wrong, is often hidden. And you need perspective to focus on root causes. And we think that that would be useful and would be assisted by an audit committee structure.

Senator GRAHAM. We've been focusing on this issue to some degree as if it were an inanimate object. In fact, of course, we're talking about complicated political and social programs, and we are asking "how well are we controlling the resources that go into those programs for management purposes, to avoid fraud and abuse." I was struck that on two of the three programs that we focused on during our discussion with Panel Two, the agency's response is to essentially terminate a program.

You could solve every management problem in the Federal Government if you terminated every program. If you terminated the Air Force, the Bureau of Prisons, section 8, and every other program, we would have no more managerial control issues. I'm concerned that as part of this review process, particularly as it comes to the Congress for its oversight, that another level of questions be asked and some data be generated to help answer them. And that inquiry is "what was it that led us to establish this program in the first place, and what is the effectiveness and efficiency impact on that goal, and to what degree is that efficiency and effectiveness being retarded or advanced by our internal control and resource surveillance system?"

Would your recommendation include any dimension of that efficiency or effectiveness?

Mr. CHAPIN. Oh, yes. I think you would have a wonderful opportunity to question the agency about the effectiveness of their programs; not only about the systems and controls and so on, but whether these programs are really working, whether section 8 really should be on the books. There were a lot of questions about that over many years. This kind of an oversight hearing would give you the opportunity to get into those matters, and have people answer questions.

Senator GRAHAM. Mr. Chapin, how long have you been in your current position, or in the General Accounting Office?

Mr. CHAPIN. It seems like a long time, but it's only since October.

Senator GRAHAM. I was going to ask a question that required somewhat of a longer historical——

Mr. STEINHOFF. I've been there for a long time.

Senator GRAHAM. Are there any role models that you are aware of that you think are working? Are there agencies which have had a history of serious internal scrutiny of their operations and a commitment to rectifying problems, and a relationship with the President, or the Office of Management and Budget, or Congress, that gave some of the external perspective that apparently was lacking here?

Mr. STEINHOFF. We are often times asked that.

Senator GRAHAM. So you have an answer ready?

Mr. STEINHOFF. I have an answer. Across the board, we think today, there are serious financial management and internal control problems. Every department has major challenges they face. The IG mentioned that one of the objectives at HUD was to reduce the size. Some of that gets back to the infrastructure to manage the place. I would say that across the board, Government has a problem today with its inability to manage.

The complexity of Government grows each day; the responsibilities grow. And there's been a big push in the last 15 years to hold it down. Typically, it's held down in terms of FTE's, or staff, or new systems, or travel, things like this. And we have reported, in the past, that the Government must deal with some of the qualities of the infrastructure.

For example, we did a lot of work in the IRS; they have serious problems today. And they have a very major task and they're trying to rebuild. We see these kinds of things across the board. I would say that it seems to me that people are generally concerned and people are trying to address the problems they have, but they certainly aren't there, yet. Also, the cloud at HUD did have a proverbial silver lining because it has put emphasis on this across the board. But I wouldn't give anybody today high marks; I would say many are trying.

Mr. CHAPIN. I would like to not necessarily add to what Mr. Steinhoff has said, but rather to say that Richard Darman has indicated that there are a number of agencies who are unauditable. I believe that to be the case, as well.

You have a very serious financial management problem throughout the Government. There are some that are auditable; there are many that are not. I'm talking about the agencies, now.

And I believe that's a very serious concern, and it relates directly to the FIA problems that we're all hearing about. Because, if you can't produce audited financial statements, your systems are not very good. Your controls are not very good. And there are HUDs out there, or potential HUDs out there, that are going to happen, and we don't have it under control.

Senator GRAHAM. Your last paragraph may have answered the question with which I am going to conclude this round. In this single committee, the Banking, Housing, and Urban Affairs Committee, in the last 18 months, we have gone from the solace of being assured that the situation was under control to accepting two of the greatest financial debacles in our nation's history: savings & loan, and here, today, HUD.

Are you suggesting that there may be some other of those buried land mines out there waiting to explode on us unexpectedly?

Mr. CHAPIN. Yes, I am. There surely are more major problems out there.

Senator GRAHAM. If it was your job to try to go out and uncover the most lethal of those land mines before they went off, where you would start looking first?

Mr. CHAPIN. We have used our best judgment, and outlined in our testimony 14 areas where we believe that the most serious risks are in Government. It's a judgment call. It could be that many on the OMB list are more important, but we've used our best judgment to try to identify the most critical ones. These are the ones that, with our resources, we're trying to address in as rapid a fashion as possible.

I would also add that we are also directing our financial audit efforts toward these risk areas, trying to, in effect, not only look at them from the point of view of the specific controls, but to look at the agencies where these problems are in terms of what the financial audit shows. I think that's where we can really get a handle on this when we have the financial audits.

Mr. OLS. Mr. Chairman, if I might add something.

I don't have a model, and, as Don has just stated, I'm not sure there is one. We've got a lot of problems in a lot of financial activities. But when I took over our responsibility at HUD, roughly about 14 or 15 months ago, one of the things that I noticed right away is that I could not go in and find out what was going on in certain programs, for financial reporting or just management. How many clients are we serving, how many houses are out there, how many foreclosed properties do we have?

All of that ties back to what we're talking about in the financial arena of what's going on. They've been coming up here year after year, and you're asking them, have you got audited financial statements. And they kept saying, no. Finally, somebody was going to have to take some kind of action. But HUD was really avoiding that.

I think in my experience with GAO, which spans numerous years—I won't say how many but numerous years, that in fact, that's the worst I've ever seen in any operation. You couldn't go in and get some basic program information about what was going on, whether it be section 8, Mod, Rehab, coinsurance, or anything. I was shocked. And I heard Mr. DelliBovi say that he in fact saw the same thing. You just see it; it's right there. And you can't manage without that basic MIS type of information.

Senator GRAHAM. Senator Mack?

Senator MACK. Most of us have focused, frankly, during this past year on Sam Pierce. And what I'm hearing now in the discussions, really, maybe we could go back to the beginning and say, there never has been put into place an adequate financial reporting system, internal control system at HUD. And it's been an accumulation of all these different programs and different administrations over the years. Nothing's ever been pulled together until the crisis hit. Is that?

Mr. OLS. I would agree with you, from my perspective. Looking back on it, as I've looked back on what was going on, one of the things I think might bring that to light and Mr. DelliBovi talked about the number of handbooks and number of programs at HUD. If you stack all those up on all the programs, you'd probably fill this entire conference table right here with all the rules and regulations that every employee has to follow in whatever program they're on.

That's not so bad at headquarters because they have them divided. When you get out into the regional areas where the programs are carried out, it's the same individual that has to know everyone of those. And I think that is where it starts becoming a real problem on how do you control those programs. How do you know you're even doing the right thing, even though you're intentions are there and you want to do the best you can?

And I think those are some of the problems and they are, from my experience and the work that we're doing with my staff over there at HUD, looking into a lot of those. They are not in any way there yet. They're not correcting everything, but they are working toward that. I would give them high marks for making that effort to move.

Mr. STEINHOFF. If I could kind of add to that a little bit, Senator Mack.

If you look on pages 2 and 3 of Mr. Chapin's statement, we have a quote in here that goes back 24 years, which is entitled "The

Stench at FHA." And it basically lays out the kind of problems that we saw a year ago. These are not new things.

Senator MACK. Maybe to close on a positive note, when you were pointing out that a couple of the programs over there that the response was to terminate the programs, at least they didn't come to us and say that they wanted to terminate HUD.

Senator GRAHAM. Yes, I guess that's true. We don't have creeping incrementalism but I hope to end on a positive note. But before we get too positive, I am struck with the list of the 14 areas that you indicated you felt were the most susceptible of being that buried land mine, a number of them that are the responsibility of this committee, in terms of the committee of authorization. Leading the list is the Resolution Trust Corporation, and the Urban Mass Transportation Administration, and I guess as a mixed authorization is the Guaranteed Student Loan Program. So this committee has got a lot of work to do to be responsive to your identifying list.

To return to a question I was asking earlier about the efficiency and effectiveness question. Do you think that the FIA report should be expanded from its current focus on controls to also include program efficiency and effectiveness measures? Or should there be some other method of systematically servicing those questions?

Mr. CHAPIN. I really haven't given that a lot of thought, Senator.

I think we've got a huge problem with systems and controls, and I hate to think of trying to expand. This obviously needs to be addressed, efficiency in Government needs to be addressed; but I would, offhand, think it might be counterproductive to try to expand the coverage of FIA into these other areas.

Senator GRAHAM. But you felt that your recommendations, such as the chief financial officer concept, would surface efficiency and effectiveness measures, as well as internal controls.

Mr. CHAPIN. Yes.

Senator GRAHAM. Mr. Chapin, Mr. Ols, Mr. Steinhoff, thank you very much. We appreciate your significant contributions to this hearing.

[Whereupon, at 4:45 p.m., the hearing was concluded.]

[Additional material supplied for the record follows:]

CHART A

HUD'S MOST SERIOUS EXISTING MATERIAL WEAKNESSES

(AS SELECTED AND DESCRIBED BY HUD IN ITS 1989 FMFIA REPORT)

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(1) PUBLIC HOUSING: MANAGEMENT OF MODERNIZATION PROJECTS (IDENTIFIED BY HUD IN 1988)

(A) INAPPROPRIATE DELEGATION OF PROGRAM FUNCTION
(B) LACK OF EFFECTIVE MONITORING

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(2) HOUSING: SINGLE FAMILY LOAN ORIGINATION (IDENTIFIED BY HUD IN 1987)

(A) INFLATED APPRAISALS CAUSING HIGH LOAN-TO-VALUE RATIOS
(B) INADEQUATE APPRAISAL REVIEW PROCESS
(C) INACTION TO REMOVE POORLY PERFORMING APPRAISERS

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(3) HOUSING: SINGLE FAMILY PROPERTY DISPOSITION (IDENTIFIED BY HUD IN 1987)

(A) INEFFECTIVE PROCEDURES TO ASSURE TIMELY SUBMISSION OF SALES PROCEEDS AND PACKAGES BY CLOSING AGENTS
(B) INADEQUATE MONITORING OF CLOSING AGENTS AND FAILURE TO PLACE AGENTS UNDER STANDARD CONTRACTS
(C) POOR QUALITY MANAGEMENT INFORMATION SYSTEMS

(4) HOUSING: SECTION 8 SUBSIDY PAYMENT PROCESS (IDENTIFIED BY HUD IN 1983)

(A) NO UNIFORM PROCESS FOR CERTIFYING ACCURACY OF PAYMENT VOUCHERS AND REQUISITIONS
(B) MANAGEMENT AND ACCOUNTING SYSTEMS INADEQUATE
(C) PROGRAM MANAGEMENT AND ACCOUNTABILITY FRAGMENTED

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(5) HOUSING: MULTIFAMILY COINSURANCE PROGRAM (IDENTIFIED BY HUD IN 1988)

(A) WEAK PROGRAM STANDARDS
(B) WEAK UNDERWRITING STANDARDS
(C) INEFFECTIVE MONITORING
(D) LACK OF ENFORCEMENT

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(6) HOUSING: SECTION 8 MOD REHAB PROGRAM (IDENTIFIED BY HUD IN 1988)

(A) INEFFECTIVE MONITORING AND ENFORCEMENT
(B) INAPPROPRIATE SKILL LEVEL OF HUD AND PHA STAFF
(C) EXCESSIVE SUBSIDIES OFTEN AFFORDED

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(7) HOUSING: USE OF ASSETS OF MULTIFAMILY PROJECTS (IDENTIFIED BY HUD IN 1987)

(A) INEFFECTIVE LEGAL AND ADMINISTRATIVE REMEDIES TO ADDRESS VIOLATIONS
(B) INADEQUATE SYSTEM FOR DEFINING AND IDENTIFYING TROUBLED PROJECTS
(C) LACK OF AN AUTOMATED SYSTEM TO MONITOR AND SERVICE LOANS

(8) HOUSING: TITLE 1 MANUFACTURED HOUSING LOAN (IDENTIFIED BY HUD IN 1988)

(A) FAILURE TO REQUIRE NORMAL UNDERWRITING STANDARDS
(B) MANY LENDERS ARE NOT PERFORMING REQUIRED DUTIES AND ARE DEFRAUDING HUD

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(9) GENERAL: ENTITLEMENT GRANTEE MONITORING OF SUBGRANTEE PERFORMANCE (IDENTIFIED BY HUD IN 1989)

(A) FAILURE OF GRANTEES TO MONITOR SUBGRANTEES
(B) DEFICIENT CONTRACTS BETWEEN GRANTEES AND SUBGRANTEES
(C) POOR CONTROLS OF REIMBURSEMENT REQUESTS
(D) FAILURE OF HUD TO MONITOR GRANTEES EFFECTIVELY (10)

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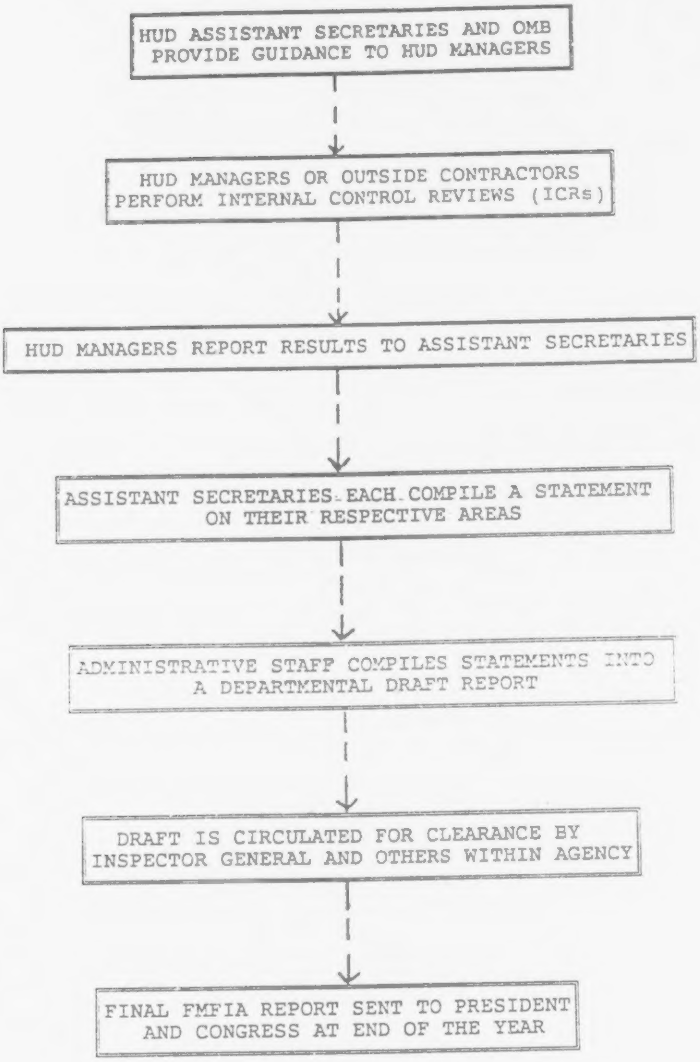
(10) GENERAL: SECTION 4 MATERIAL NONCONFORMANCES IN FINANCIAL SYSTEMS

(A) FRAGMENTED SYSTEMS
(B) INADEQUATE CONTROLS
(C) UNRELIABLE DATA
(D) MISSING INTERFACES

CHART B

HOW HUD COMPILES ITS ANNUAL FMFIA REPORTS


HUD ASSISTANT SECRETARIES AND OMB PROVIDE GUIDANCE TO HUD MANAGERS
HUD MANAGERS OR OUTSIDE CONTRACTORS PERFORM INTERNAL CONTROL REVIEWS (ICRs)
HUD MANAGERS REPORT RESULTS TO ASSISTANT SECRETARIES
ASSISTANT SECRETARIES EACH COMPILE A STATEMENT ON THEIR RESPECTIVE AREAS
ADMINISTRATIVE STAFF COMPILES STATEMENTS INTO A DEPARTMENTAL DRAFT REPORT
DRAFT IS CIRCULATED FOR CLEARANCE BY INSPECTOR GENERAL AND OTHERS WITHIN AGENCY
FINAL FMFIA REPORT SENT TO PRESIDENT AND CONGRESS AT END OF THE YEAR

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
THE SECRETARY
WASHINGTON, D.C. 20410

December 31, 1987

The President
The White House
Washington, DC 20500

Dear Mr. President:

I am pleased to inform you that the results of the evaluation of internal accounting and administrative controls, assurance statements given by officials, and other information available, for the year ended September 30, 1987, provide reasonable assurance, for those responsibility centers or subcomponents reviewed, that the Federal Managers' Financial Integrity Act (The Act) objectives were achieved, except for the material weaknesses cited in Enclosure C and the limitations cited in Enclosure B. A statistical summary of our performance is shown in Enclosure A. This year's detailed evaluation process is also described in Enclosure B.

In addition, pursuant to Section 4 of The Act, we completed a review of our accounting systems in use during Fiscal Year 1987 and we can now report substantial compliance with the Office of Management and Budget (OMB) and General Accounting Office standards. A detailed evaluation of our Department's review process for Section 4 is delineated in Enclosure D.

The Department has made significant progress in implementing a formal, comprehensive, and effective management control program. In addition, we have made significant efforts to achieve financial management improvement goals of the "Reform '88" program. High priority has been given to the areas of cash and credit management and system efficiency and integrity.

We have increased our use of electronic transfers of funds to collect amounts due and to make payments. Approximately 98 percent of our cash receipts are now collected electronically and approximately 65 percent of our disbursements are now made by electronic means. These efforts have resulted in cash management savings of millions of dollars. During 1988, we anticipate further expansions of these efforts.

In the credit management area, we have implemented reporting of debts to the Internal Revenue Service and to credit bureaus. We have also implemented state-of-the-art technology, such as automatic calling systems to improve cash collections and an electronic system to alert mortgagees to credit risks for Federal Housing Administration (FHA) insurance programs. With the assistance of the Inspector General, we have increased our oversight of mortgagees and others involved in the FHA programs to reduce fraud.

In improving our financial systems, we are currently converting our payroll system to a cross-servicing arrangement with the Department of Agriculture's National Finance Center. We are also in the process of upgrading the automated interfaces between our systems and adopting the Standard General Ledger. Additionally, we are working to reduce the number of component financial systems through integration and modernization.

Many of our improvement efforts have been accomplished through new technology. In addition to specific improvements related to the above, the Department has also underway a major effort to upgrade our computer hardware and our telecommunications networks.

These efforts, and many others completed or in process, represent a coordinated effort by the Department to improve our operations in order to achieve the maximum economy and efficiency and to prevent fraud, waste, and mismanagement. We have developed a 5-Year Management Control Plan which highlights our scheduled reviews. The Plan will be submitted to OMB under separate cover. We have made these efforts an integral part of the operations of the Department and will continue to ensure that our operations reflect your goals embodied in "Reform '88."

Please be assured that I will maintain our commitment to improving the efficiency and effectiveness of our programs through improved internal controls.

Respectfully,

Samuel R Pierce Jr

Samuel R. Pierce, Jr.

Enclosures

THE DEPARTMENT'S EVALUATION PROCESS FOR SECTION 4

Pursuant to Section 4 of The Act, we completed a review of our accounting systems in use during Fiscal Year 1987, and we can now report substantial compliance with the Office of Management and Budget (OMB) and General Accounting Office standards. The review was made in accordance with the Guidelines for Evaluating Financial Management/ Accounting Systems issued by OMB, and based on the principles and standards developed by the Comptroller General and implemented through OMB Circular A-127.

This review revealed no areas of material nonconformance. A number of recommendations have been made covering various systems to improve our conformance. These recommendations which will be included in our 5-year Management Control Plan include improvements in:

-- Coordination with Treasury on cancelled and/or returned payments and centralization of responsibilities;

-- Timeliness of deobligations and payments;

-- Reporting and use of reports for supervisory review;

-- Enhancements to reporting in accordance with Generally Accepted Accounting Principals (GAAP), where applicable;

-- Interfaces between automated component systems; and

-- Planning for the termination of systems superseded by system integration efforts.

An A-127 review was also made of the Federal Housing Administration (FHA) reporting in accordance with GAAP. This review indicated that FHA accounting and reporting are substantially in conformance with GAAP, and a number of reporting areas were identified where compliance with GAAP will need to be reevaluated each year to ensure that all economic events and changes are adequately accounted for and reported. Corrective actions are underway to achieve full conformance with GAAP.

During Fiscal Year 1987, we began pilot testing of the computer software that will be used to implement the Standard General Ledger during Fiscal Year 1988. We are currently ahead of schedule on this project and have already developed sample reports for a number of major projects using Fiscal Year 1987 data. All related components in HUD will have the same coding structure. HUD plans to have two financial systems by the end of Fiscal Year 1988, a primary accounting system and the FHA system. The primary accounting system will be the system developed using Management Services of America software and will contain the Standard General Ledger. All administrative and program accounting data, including FHA, will feed into this system. Interfaces between component systems are currently being developed. HUD's key program and administrative systems already interface electronically. HUD plans to cross-service its payroll/personnel system using the National Finance Center's system during Fiscal Year 1988.

HUD is awaiting a direct electronic link to Treasury. However, we are continuing to expand the use of existing Treasury Automated Clearing House payments system. HUD plans to combine compliance testing for OMB Circulars A-123, A-127, and A-130 during Fiscal Year 1988. All financial systems improvements are addressed in HUD's 5-year Financial Management Systems Plan.

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
THE SECRETARY
WASHINGTON, D.C. 20410-0001

December 29, 1989

(ENCLOSURES OMITTED)

The President
The White House
Washington, DC 20500

Dear Mr. President:

This report describes the actions taken and future plans developed by the Department of Housing and Urban Development (HUD) during Fiscal Year 1989 to bring the Department into compliance with the Federal Managers' Financial Integrity Act of 1982.

Shortly after taking office, I became aware of a myriad of serious material weaknesses in the Department's internal controls and financial management systems. These flaws, which have existed for many years, have led to fraud, waste, abuse, and mismanagement of numerous HUD programs.

For example, in past years, discretionary funds were used to bypass the competitive process where funding decisions are based on need and merit. Poor documentation and little internal control allowed funds to be awarded arbitrarily based solely on political influence, with no public scrutiny.

The Federal Housing Administration (FHA) had not been audited since 1974. Its internal financial reports were done merely on a cash basis, not the accrual basis necessary to accurately portray the condition of the fund. In the first complete, independent audit in fifteen years, Price Waterhouse and the General Accounting Office reported a $4.2 billion accrual basis loss for FHA in Fiscal Year 1988.

The coinsurance program has been identified as HUD's top material weakness. This program delegates underwriting and management functions, as well as commitment authority, to private lenders in return for the lenders' assumption of a portion of the loan risk. According to a GAO audit, the program sustained $960 million in losses for Fiscal Year 1988. These losses were attributable to poor underwriting by the coinsuring lenders as well as weak monitoring and enforcement by HUD. The GAO audit indicated that future losses are likely from defaults of mortgages originated before 1989.

The Department has taken numerous actions to identify systemic problems and develop recommendations to improve financial management controls. I have established a special Task Force on Program Financial Management headed by Under Secretary Alfred DelliBovi to strengthen financial management in 26 program activities.

Furthermore, I will soon appoint a Chief Financial Officer for the Department who will be responsible for overhauling accounting and financial reporting policies, and ensuring the development and operation of a sound financial management system. An FHA Comptroller will also be selected. Annual financial statements will be prepared and audited by an independent accounting firm beginning with Fiscal Year 1990.

In addition, I announced and Congress recently passed a comprehensive package of reforms designed to restore ethical, managerial, and financial integrity to HUD's programs. They include elimination of discretionary funding; registration of consultants and disclosure of fees; and the authorization to impose civil money penalties. I applaud the swiftness with which Congress passed these measures, and I intend to fully and expeditiously implement them.

While the foundation has been put in place to ensure that actions are set in motion for correcting weaknesses in financial management, the Department is not yet in full compliance with the standards required by Sections 2 and 4 of the Federal Managers' Financial Integrity Act. HUD's internal accounting and administrative controls, as well as HUD's accounting systems, do not conform to the principles, standards, and related requirements prescribed by the Comptroller General.

Exhibit 1 summarizes what I consider to be our most serious material weaknesses. It also summarizes HUD's general non-conformance with GAO requirements for financial management systems.

With the continued bipartisan support of Congress, I am confident that these material weaknesses can be resolved, and that HUD can return to its historic mission of restoring hope and opportunity for needy Americans.

Very sincerely yours,

Jack Kemp

Enclosures

1. Statistical Summary of Performance
2. Summary of the Internal Controls Review Process
3. Description of Material Weaknesses and Major Milestones for Corrective Actions
4. Material Nonconformance in Financial Systems

(Created by HUD for testimony of Under Secretary DelliBovi)

HUD Material Weakness Number 1

Multifamily Coinsurance Programs (88-7)

Program Weaknesses

- It was erroneously believed lenders would be "self-policing" since their own capital would also be at risk
  - .. Unscrupulous lenders inflated mortgage amounts which could not be supported by project incomes and made their money by charging large "up front" fees
- Weak program standards allowed inexperienced and undercapitalized lender participants to be approved
- Weak underwriting standards
- A lack of monitoring and enforcement

Program Impact

- Program weaknesses were found to be so profound the Secretary found it necessary to terminate the program
- In March 1990, coinsurance defaults were $1.6 billion, 18% of the coinsurance in force

HUD's Plan to Correct the Weaknesses

- Terminate the coinsurance program
  - .. Since January 17, 1989, all commitments for coinsured loans have been subject to HUD's precommitment review
  - .. Our proposed rules for final program termination were published for comment in the Federal Register last month
- Replace the program with a new delegated processing system for full insurance
  - .. HUD will retain ultimate responsibility for underwriting loan commitments

Timetable

- We had planned to issue the final coinsurance terminating regulation in late July, but now intend to allow coinsuring lenders (who have not been suspended) to continue processing loans until the new system is in place.

HUD Material Weakness Number 2

Section 8 Subsidy Payment Process (83-1)

Program Weaknesses

- No uniform process for reviewing and certifying accuracy of payment requests
- Inadequate incentives for Public Housing Authorities (PHAs) and owners to submit timely and correct tenant recertifications
- No requirement for Field Office to review and approve payment requests prior to payment
- No process to reconcile payment requests paid by accounting with copies sent to Field Offices for review
- Management and accounting systems are inadequate
- Program management and accountability is fragmented within HUD Headquarters and between Headquarters and the Field

Program Impact

- HUD pays excessive subsidies
  - .. Tenant income understated
  - .. Ineligible tenants admitted
  - .. Payments made for ineligible items
  - .. HUD cannot detect or collect overpayments
- Payment requests from PHAs and owners are not processed timely or accurately

HUD's Plans to Correct Weakness

- HUD has contracted with Arthur Andersen to review subsidy payment process for:
  - .. All Section 8 programs
  - .. Section 236 (Multifamily Mortgage Reduction program)
  - .. Rent Supplement Program

Timetable

- Arthur Andersen study to be complete by June 15, 1990
  - .. Study will provide a detailed action plan designed to correct the problems
  - .. Timetable to implement action plan will not be known until June, 1990

HUD Material Weakness Number 3

Title I Manufactured Housing Loans (88-11)

Program Weaknesses

- Program fails to require normal real estate underwriting standards
  - .. Formal closing
  - .. Face-to-face meeting between lender and borrower
  - .. Property inspection
- Many lenders falsify loan documents, do not properly evaluate borrower's credit worthiness, and do not monitor dealer compliance
- Items that add no value to the home are included in the loan

Program Impact

- Significant number of defaults
  - .. Projected claims against FHA and GNMA exceed $500 million

HUD's Plans to Correct Weakness

- Issued a final rule making major program changes
  - .. Prohibit use of loans to purchase furniture
  - .. Limit hazard insurance permitted in loan
  - .. Increase insurance premium and collect more of the premium during the early years when default risk is greatest
- Conduct a comprehensive program reexamination
  - .. Issue regulation implementing program redesign based on program reexamination

Timetable

- Target date for issuing program redesign regulation is September 15, 1990. Based on outcome of program reexamination, additional corrective actions may be identified and implemented by dates to be determined

HUD Material Weakness Number 4

Use of Assets and Income of Multifamily Insured and HUD Held Projects (87-4)

Program Weaknesses

- Inadequate monitoring of projects
- Ineffective legal and administrative remedies for violations of regulatory agreements
- Inadequate criteria for defining and identifying troubled projects
- Lack of an automated system to monitor and service loans
- Inadequate staffing to assure timely and complete analysis of audited project financial statements and inspection reports

Program Impact

- Diversion of project assets and increased FHA fund losses in the form of additional subsidies and claims
- Reduction in quality of life for tenants as funds are not available to support project maintenance

HUD's Plans to Correct Weakness

- Instituted double damages for equity skimming
  - .. Collecting rent and not applying to mortgage
  - .. Taking money from project operating account for personal use
  - .. Making distributions to partners when project is not generating cash
- Implemented an automated system to analyze audited financial statements and flag possible violations
- Revised and updated program handbook
- Formed a task force to develop policy on misuse and diversion of assets
- Issue a regulation implementing civil money penalties against projects that violate regulatory agreements and other regulations

Timetable

- Actions described above are scheduled for completion by October 31, 1990. Additional corrective actions are being developed and may well extend beyond October, 1990

HUD Material Weakness Number 5

Section 8 Moderate Rehabilitation Program (88-8)

Program Weaknesses

- Ineffective monitoring and regulation enforcement by HUD Field Offices enabled PHAs, developers and lenders to circumvent HUD requirements
- Insufficiently trained Field and PHA staff were unable to ensure compliance with regulations and handbooks

Program Impact

- Project selection was often based on favoritism resulting in projects most in need not being funded
- Excessive subsidies were allowed due to a lack of cost containment devices
- Unnecessary tax credits were afforded to developers in addition to the Section 8 subsidy

HUD's Plan to Correct the Weaknesses

- HUD cancelled funds not under contract with PHAs. At the request of Congress, selections were not made in FY 1989 and funds were carried over
- Transferred responsibility for establishing contract rents in coinsured projects from private lenders to the Field Offices
- Assembled a team of the best experienced Field staff
  - .. Trained the team and sent them to 50 PHAs to review inprocess projects
  - .. The team reviewed projects; and in extreme cases, contracts were terminated and readvertised
- 150 Field staff have been trained and will review the rents of the 300 Section 8 Moderate Rehabilitation projects approved since 1984
- Provisions of HR-1 are being captured in 2 Notices of Funding Availability (NOFAs)

Timetable

- The NOFAs will be published in June and the review of the 300 projects completed in December

HUD Material Weakness Number 6

Title I Supervision of Home Improvement Dealers and Brokers by Mortgage Lenders (86-1)

Program Weaknesses

- Lack of effective monitoring by HUD staff
- Inappropriate delegation of program function to program participants
  - .. Dealers prepare borrower application

Program Impact

- Conflict of interest between home improvement contractors and loan brokers results in consumer fraud
  - .. Excessive costs
  - .. Shoddy work
- Borrowers are qualified who are unable to repay loan
  - .. High loan default rate

HUD's Plans to Correct Weakness

- Secretary proposed to eliminate dealers from program participation
  - .. Congress did not accept recommendation
- Issue regulations to tighten dealer participation in loan origination
  - .. Lenders must adopt more stringent underwriting procedures to verify borrower financial information
  - .. Loans limited to owner-occupants
  - .. Loans limited to residential structures
  - .. Lenders held responsible for actions of dealers
- Issue regulations implementing civil money penalties upon dealers who provide false information on loan applications
- Implement increased program monitoring and enforcement actions

Timetable

- Regulations are scheduled to be issued by September 21, 1990

HUD Material Weakness Number 7

Management of Public Housing Modernization Projects (88-3)

Program Weakness

- There is insufficient oversight and technical guidance of the Comprehensive Improvement Assistance Program (CIAP) by HUD and the administering Public Housing Administrations (PHAs)

Program Impact

- Modernization funds may have been approved for inviable projects
- Cost overruns occurred without HUD approval
- Improper award and administration of contracts
- Unsupported and ineligible modernization costs

HUD's Plan to Correct the Weakness

- HUD has doubled the number of monitoring visits
- Revised CIAP related regulations and the CIAP Handbook

  .. Completed Field staff training on the revisions
- HUD has shifted from a two stage to a single stage application process
- Intend to issue an additional handbook containing instructions on submission, review and approval of modernization applications

Timetable

- Actions are completed except for issuing the additional handbook which is waiting for OMB clearance. We hope to have completed issuance by February 1991.

HUD Material Weakness Number 8

Entitlement Grantee Monitoring of Subgrantee Performance (89-3)

Program Weaknesses

- Failure of HUD to monitor grantees effectively
- Failure of grantees to monitor subgrantees effectively
    - .. Including follow-up to ensure their monitoring findings were satisfactorily resolved

Program Impact

- Allowed deficient contracts between grantees and subgrantees
- Government funds have been wasted
    - .. Subgrantees have failed to perform contracted services
    - .. Significant ineligible and unsupported costs
    - .. Budgets not subdivided to track individual project funding

HUD's Plan to Correct the Weaknesses

- Trained HUD staff, at the 16 Field Offices with the highest CDBG activities, in conducting on-site monitoring
- Issued regulations which:
    - .. Require grantee monitoring of subgrantee on a day-to-day basis
    - .. Requires a written agreement between the grantee and subgrantee which spells out use of funds, services to be provided and reporting requirements
- Are reviewing potential punitive actions against grantees
    - .. Withholding funds from grantee and subgrantee
- Are examining grantee monitoring systems for possible adoption

Timetable

- We are on track to have corrected this weakness by June 30th of this year

HUD Material Weakness Number 9

Single Family Property Loan Origination - Appraisals (87-2)

Program Weaknesses

- Inadequate Field Office selection and review of contract fee appraisers to appraise acquired single family properties and review appraisals
- Poorly performing fee appraisers are not always sanctioned or denied HUD business

Program Impact

- Fee appraisers inflate appraisals of single family homes
    - .. Creates high loan to value ratio
    - .. If default occurs, HUD pays mortgage claim in excess of property value

HUD's Plans to Correct Weakness

- Computer system modified to track the percentage of appraisals reviewed and issue warnings if percentage decreases below standard
- Computer system modified to track manual overrides of computer's selection of fee appraisers
    - .. Supervisors must review overrides
- Issued directives requiring that all fee appraisers must meet state certification and licensing requirements
- Required participating lenders develop quality control plans to monitor their loan origination activities
    - .. Internal and external audits of origination activities required
    - .. Failure to comply is grounds for withdrawal of FHA approval to participate in insurance programs
- Initiate ongoing review of Field Office removal/sanctioning of fee appraisers who fail to meet HUD standards
- Enhance computer system to randomly select appraisals to be reviewed by Field staff

Timetable

- Corrective actions are scheduled to be completed by January 31, 1991

HUD Material Weakness Number 10

Single Family Property Disposition Closing Activities (87-3)

Program Weaknesses

- Ineffective procedures for assuring receipt of funds
- Inadequate monitoring of closing agents
- Closing agents not under standard contract
- Incomplete documentation supporting sales
- Wire transfers of funds not confirmed
- Inadequate accounting and property management systems
    - .. Current systems do not talk to each other
    - .. Data must be manually reconciled
    - .. Data quality is poor

Program Impact

- Closing agents have not transmitted monies due HUD or have transmitted them late
    - .. Resulted in fraud (Robin HUD)
    - .. Results in significant losses to FHA fund

HUD's Plans to Correct Weakness

- Issued directives to Field Offices for monitoring closing agents and assuring standard contracts are in place
- Developed statistical reports to measure timeliness of proceeds deposits and submission of sales packages to Headquarters
- Increased bonding requirements on closing agents and required bi-monthly on-site inspections of closing agents
- Developed exception reports to detect and reduce data entry errors
- Established a research team to reconcile unmatched sales packages and proceeds
- Began pilot testing the Single Family Accounting and Management System (SAMS) to replace current incompatible accounting and property management systems

Timetable

- Nationwide implementation of SAMS scheduled for September 30, 1991

U. S. Senate HUD Mod Rehab Investigation
April 8, 1990 Hearing Response
by Watson Rice and Company CPAs
May 14, 1990
Page 1

Background:

1. Imposition of Price Waterhouse - The contract for HUD's first A-127 review was negotiated with Watson Rice and Company (WRC) after a technical competition among qualified firms. HUD requested that the resulting contract staffing and work plans be revised twice to include provisions for Price Waterhouse (PW).

The first of these revisions removed approximately $350,000 from tasks related to the of A-123 compliance review. This money was allocated to PW for review of FHA financial statements for compliance with generally accepted accounting principles (GAAP). As a part of this subcontract, WRC and PW agreed to join together on any future engagements that resulted from this initial engagement. This was not to happen. In fact, PW excluded WRC from forthcoming contract opportunities and worked to sully WRC's professional reputation with HUD. See HUD Board of Contract Appeals (HUD BCA) transcript pages 205; 206; 257 and 259.

The second contract revision removed a like amount of funds from the WRC portion of the contract and reallocated the funds to PW to enable them to perform work originally assigned to WRC professionals.

The third revision resulted from an agreement between WRC and PW, without coercion from HUD. WRC agreed to allocate money to PW for completion of the final report. At that time, WRC's staff had been devastated, many WRC professionals had resigned to pursue other employment because the future of WRC was doubtful.

Throughout the entire contracting period there was considerable pressure on WRC to include PW and then to expand the PW role. See HUD BCA Transcript pages 122; 124; 132; 133; 147; 150; 155; 156; 164; 251 and 252.

2. Disagreement on Scope - There was a disagreement on the scope of the A-127 review among various factions of HUD's staff. WRC was of believed that an A-127 review like an A-123 review was a management services engagement, requiring the leadership of computer systems professionals. Certain HUD professionals considered the A-127 review to be an audit engagement requiring the leadership of audit professionals. See HUD BCA transcript pages 240; 260; 261.

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HUD initiated a staff change, replacing WRC staff with PW staff, as a result of this disagreement. Assigned WRC professionals were computer systems technicians while the PW professionals imposed by HUD audit professionals/CPAs.

It is this disagreement that fueled the opinions expressed by the HUD/IG staff. They are auditors, and supported the position that the work being performed was audit work, to be carried out by auditors using auditing standards and procedures. The original budget, before the above delineated cuts, did not provide sufficient funding for an audit of HUD's compliance with OMB Circular A-127, nor is an audit required by the provisions of the Circular.

An audit report would have offered positive assurances that the systems were in compliance with A-127 and A-123. Words such as the following would have been in the auditors report "In our opinion the financial systems of the United States Department of Housing and Urban Development were in compliance with all relevant requirements of OMB Circular A-127 and were sufficient to safeguard the assets of the government....". Also, the report would then have been signed by the audit firm. No such language is in the WRC/PW final report or the interim reports on specific systems. The final report is not signed nor does it contain an "Auditors' Report". Interim technical reports do not contain auditors reports or language, as indicated above.

3. Long Term Agreement Between WRC and PW - As an inducement for WRC to include PW's FHA work in the initial contract, WRC was offered and accepted a long term agreement between the two firms that provided for them to operate as a team on any future work that developed from this initial opportunity. See P. Lohnies and A. Lombard testimony HUD BCA transcript page 205; 206; 257; and 259.

Observations:

1. On one hand, all mention of Price Waterhouse (PW) is missing from any witness' discussion of our final or interim reports on HUD's compliance with OMB Circular A-127. The omission is particularly interesting considering that PW compiled the final report and performed about half of the work performed under the contract.

On the other hand, a Price Waterhouse/GAO report critical of the FHA's accounting systems and reports was referenced. This PW work was related to the A-127 review and was performed by some of the same PW staff. How can one document be worthy of reference status while another very similar document be designated substandard work?

2. HUD/IG was invited by HUD counsel to appear in an administrative hearing before the HUD Board of Contract Appeals. After testimony by WRC professionals outlining the work performed, and documentation of the American Institute of CPAs opinion on such work, the HUD/IG was removed from the witness list. Why?

3. Watson Rice and Company's (WRC) work is subject to Peer Review. Such a review was conducted in 1989 under the supervision of the Peer Review Committee of the American Institute of CPAs. This review included the work done by WRC for HUD and other federal departments under OMB Circulars A-123 and A-127. The conclusion of this Peer Review was that WRC's "system of quality control for the accounting and auditing practice...met the objectives of quality control standards established by the AICPA..."

Specifics:

1. WRC/PW did raise questions about the reliability of HUD's financial systems. HUD's Janice Combs testifies on your page 58 and 59 that WRC/PW's report stated that HUD was not in full compliance with GAO accounting principles and standards. If you read the items listed as weaknesses to be resolved for each system, you will find substantial issues uncovered and reported by WRC/PW.

This type of review was being performed for the first time in the federal government. See HUD BCA transcript page 118. WRC/PW established procedures and standards as we proceeded with the engagement. These procedures were becoming industry standards for this type of system review. Along the way deficiencies were pointed out to HUD, discussed and reported, as deemed appropriate in this new process.

Also, WRC/PW expected that this would be the first of several such reviews we conducted for HUD. It was anticipated that many of the problems identified would be resolvable in time. However, we did not discuss our findings or any elements of this scope or service with Secretary Pierce or anyone in his office. Discussions were limited to the Office of Finance and Accounting (OFA) by those to whom we were reporting in OFA. We were not invited to meet with higher levels of management and did not have access to them.

2. On page 65, Mr. Dellibovi states that he did not read or review the WRC/PW report on HUD's compliance with A-127. We are not aware of any management personnel in either administration who may have read the report. If they had read the report and invited WRC/PW to discuss our findings with them, this might have been a much different hearing.

3. On page 65, Senator Graham refers to the report. Please provide us with a copy of the document submitted to him so that we can determine if it was the complete report issued by WRC/PW.

Also, the Senator implies that there may have been weaknesses in the A-127 contract selection process. There was in fact a technical competition under the procurement process established by the SBA 8 (a) program. WRC has performed similar work for the US Navy and has established strong professional credentials. The Senator may have been given misleading information about the quality of WRC, our professionals and our work. See HUD BCA transcript pages 113; 237 and 238.

4. On page 68 and 69, there is a discussion between Senator Graham and Ms. Janice Combs that leaves unanswered questions about the contract process and reasons thereof. See HUD BCA transcript pages 110; 111; 119; and 235 to find explanations offered by Ms Combs and Mr. Lombard, at that time. The documented explanation is the explanation given to WRC when we were invited to the technical competition for this contract. The issue presented is that HUD must move fast through the contracting process. SBA's 8 (a) program allows for faster contracting. It also allows for subcontracting significant parts of the resulting contract to major firms. The subcontracting provision permitted HUD to contract with the firm they wanted (Price Waterhouse) without sacrificing quality, because WRC had the technical qualifications and professional quality to perform the contract.

You may note that PW has continued as a subcontractor and prime contractor throughout this process - working with Grant Thornton, GAO and alone.

5. On page 72, Janice Combs states that she had questions about the adequacy of the work done by WRC/PW supporting the A-127 report issued. She indicates that this work was intended to be part of an ongoing or larger process that would give her the assurances she desired. On pages 242; 243; and 262 of the sworn testimony of the

HUD Administrative Hearing, Mr. Lombard says that the work was accepted by him as Government Technical Representative (GTR). Mr. Lombard and his supervisor, Ms. Combs, are CPAs and were qualified to make professional decisions of this nature.

Senator Mack's elaboration does not agree with Ms. Combs prior statement or her sworn testimony before the HUD Board of Contract Appeals. His insertion of Shirley Evans into the picture brings a completely false presentation of the facts. At the time that WRC/PW was performing the A-127 Review, Shirley Evans had retired. After the WRC/PW work was substantially completed, Mrs. Evans returned because her replacement had been removed by HUD management. She had no hand in managing WRC/PW's work under the A-127 contract.

Review. Any findings in the WRC/PW interim and final reports were reviewed by Janice Combs and Alan Lombard, edited and accepted by them before issuance.

Summary:

A careful review of the contract, final report and interim deliverables will disclose that WRC/PW delivered more than required under the contract. A systems inventory that was originally to be provided by HUD was developed by WRC/PW. Systems not in the original contract were reviewed by WRC/PW. An overall "Entity Wide" system review was conducted by WRC/PW.

From the beginning the HUD/IG has attacked the work performed under this contract. This is his job. However, WRC has established that the work was performed in accordance with established standards and with due professional care. Also, WRC has established that more was delivered to HUD than was paid for by HUD.

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U. S. Senate HUD Mod Rehab Investigation
April 8, 1990 Hearing Response
by Watson Rice and Company CPAs
May 14, 1990
Page 6

This is an issue of too little too late. The HUD problem is a people problem. Resolving it will require major personnel changes, adjustments to civil service employment regulations, and tenacious oversight by Congress. It is not an easy problem to solve. It can not be addressed by political appointments, new Chief Financial Officer (CFO) positions and independent reviews alone. It must be addressed at the basic level of technical competence and professional integrity of all employees of HUD.

WRC has been a victim here. We performed in good faith but did not receive a good faith response. Specifically, HUD has been unfairly enriched, PW has been introduced into a new contracting stream that was not otherwise available to them while WRC has been presented with a bill of more than $140,000 to pay for the benefits received by HUD and PW.

WRC is a small firm, now much smaller than before contracting with HUD and PW. We have been damaged, many jobs have been lost because of the financial and professional hardships caused by both HUD and PW. We are seeking relief in the courts. The process for remedying the situation has taken more than three years because we have followed the administrative route, exhausting administrative remedies before going to the courts. We followed this process, always believing that the truth in presentation of the facts and the integrity of our work would cause justice to be done.

We can not avoid speculation on the motives of those presenting incomplete information during such an important Senate investigation. Does it appear to be easier to associate WRC (a black owned firm) with Former Secretary Pierce (a black man) with the hope that the Senate will not see through this smoke screen?

Perhaps, with your current Senate investigation, the truth will come to light and justice will be done.

WRC.DC 17May90

was your position at HUD?

A Director of Financial Management Systems.

Q And how long had you been in that position?

A Two years.

Q Two years, okay.

A Approximately. I'm trying to figure the date.

Q That's good enough. Are you currently in that same position?

A Yes, sir.

Q Are you a CPA?

A Yes, sir.

Q How long have you been a CPA?

A Since 1973. Excuse me, 6, the bicentennial.

Q And have you worked at HUD during all the time that you were a CPA?

A Oh, no. I worked for the United States General Accounting Office for 12 years prior to coming with HUD.

Q And was that your only other employment since you were a CPA or did you have other assignments?

A That was my only employment.

Q Okay. What led you to consider issuing a contract of the type that is the subject of this hearing?

A OMB had stated that all executive agencies should get into compliance with A127, and have all their major financial management systems reviewed. HUD had not, up until that time that we let this contract, had not performed detailed reviews of the eight significant financial management systems, and we discussed this with Mrs. Hoffman, the Assistant Secretary for Administration, and she knew we were behind the eight-ball and needed to catch up. So it was decided to let a contract and to do it the most expeditious way, which was to let an 8A contract.

Q Now, when you say you were behind the eight-ball, does that mean that GAO had indicated that HUD was not in compliance and that their accounting systems were not up to par?

A More, we knew we had not performed detailed reviews. We had performed limited reviews, but our own inspector general office was pushing for more in depth reviews, and the Assistant Secretary had gotten a memo or a telephone call, I'm not exactly sure right now, from Carol Deneen, Associate Director at that time at OMB, and Mrs. Deneen had requested that Mrs. Hoffman inventory the financial management systems and make sure that we got in compliance with all aspects of A127.

Q So HUD, prior to this contract, was not in compliance and GAO and OMB were, in effect, breathing down your necks that you needed to get your accounting systems in order.

A We need to make sure that our accounting systems

A Yes.

Q Now you were contacted by a representative of Watson, Rice and Company as a general inquiry, by the name of Will Luck? Mr. Luck contacted you kind of in a business development posture, and asked do you have any kind of work that we might be able to do. Is that correct?

A Yes.

Q Did you know Mr. Luck before he contacted you?

A No.

Q And up until that contact, had you had any involvement with Watson, Rice and Company?

A No.

Q Had you heard of them?

A Yes.

Q How did you come to hear about them?

A Watson, Rice had contracts with other Government agencies and we were aware that they had done — not as extensive a review of A127 as we were embarking upon — but had done work, review work, related review work, and systems work for other agencies. So we were aware of their reputation as an accounting firm in the Washington, D.C. area -- very good reputation.

Q So you were aware that they had done 123 reviews, which, while that's not exactly the same, it's relevant to A127 work, is that correct?

one million four hundred something thousand or other, but -- was that the basis for the original award that would be utilized for them to do the A127 review? Watson, Rice to do the A127 review?

A It was the basis for their work. At that point in time we really hadn't laid out any specific dollars.

Q Now, there had not been any 127 reviews conducted in the Agency prior to this, isn't that correct?

A No detailed ones.

Q So you're really kind of breaking new ground in this?

A Yes.

Q There weren't any real, hard standards or parameters that you could use to determine what you could put together?

A That's right.

Q You were both kind of trying to feel your way along and really come to a way to solve this kind of really tight situation that you were in?

A Yes.

Q What happened after you received that document, if you recall?

A Well, again, it's difficult to remember all the details --

Q Sure. To the best of your knowledge. Were there subsequent meetings or did you then move right to the contract phase or --

A There were -- there were meetings, and there were at least -- there was at least one more meeting where this was presented to Mrs. Hoffman -- at least the guts of this, what was in this document -- to Mrs. Hoffman, and it was decided that the firm had a good grasp of the task to be performed and that we would go forward with procuring this.

Q Now, when you say go forward, does that mean then you went ahead and executed the contract or was there some other discussions that had to take place?

A There were discussions on the intermediate details, not the detailed work to be done, but a few more details before we actually went to the formal -- formulated the contract.

Q So it's fair to say that you really had, what we call in legal terms, a meeting of the minds? I mean HUD felt that they knew what they wanted and they felt Watson, Rice could do it; and Watson, Rice had submitted that to you, and so basically in spirit, you knew what you wanted to do and you were ready to start walking down the path except for the technical detailed procurement matters that you had to take care of. Is that fair to say?

A Yes.

Q Now this was in November of '86 -- November 24th.

Q Sure.

A — member, may have even been Mr. Luck — the possibility of attaching a GAP review option onto this contract and we had discussed this at some length.

Q When you say we, you're talking about Ellie Clark or you and Watson, Rice?

A Watson, Rice and the Department.

Q So you -- is it fair to say that you contacted Watson, Rice and said, look, we'd like to get Price Waterhouse involved in another phase of the work over here, specifically the GAP review?

A I would say it was fair to say that we knew we were going to be having a financial audit by GAO in the next year, and the prior audit, when I was still at GAO had been aborted because at that time HUD's systems -- it was decided the HUD systems were unauditable -- and we wanted to see the current state of HUD systems, given the fact that there had been a great deal of major improvements made to the Department in the last three years. And after discussing this, and knowing that this was needed, I discussed with Watson, Rice the possibility of them going in with another firm and doing that work. And --

HUD problem w/ GAO

Q I don't want to interrupt you, but just so we don't get confused here -- when you say that work, which are you talking about?

the principles behind the way that HUD accounts for their insurance operation, which is a completely different thing. One looks at transactions in the system, and one looks at accountability behind the numbers.

Q Where were you going to get the money — and not you personally -- when I say you I'm talking about the department — where was the money going to come from to pay for this GAP review, since I understood in your previous testimony when you talked with Ms. Hoffman, it was money that was going to be set aside to do the A127 as an 8A engagement? Where was this money going to come from?

A Same place the A127 money would come from.

Q From the 8A set aside?

A Yes.

Q Okay. Price Waterhouse is not an 8A firm, are they?

A No, not to my knowledge.

Q I think we can take judicial notice that Price Waterhouse is not an 8A firm. Well, I'm just a little curious. How were they going to be able to participate in this if they weren't an 8A firm?

MR. GRANT: Excuse me, I'm not sure I'm objecting, but counsel may be going someplace with this, but I can't see the relevance, necessarily, at this point as to the issue of whether or not there was a change made. I fail to in terms of the break-out, if in fact, and if this question is confusing I can break it down — well, let me cut it off right there. Because I don't want to confuse you. How did you envision that happening? There was money set.aside for A127. Now you're imposing another player in the game, if you will.

A I don't think imposing is --

Q Introducing.

A Okay. Introducing. We separated it and we discussed with Watson, Rice -- not Price Waterhouse -- but Watson, Rice, the possibility of doing an A127 review, and we discussed how much money that would be. They went -- they came with figures about how much money that would be, after we got down the line, and then we said if we tacked on a GAP review and asked them if they would be willing to accommodate that; could they talk with a firm such as Price Waterhouse and get some details on that. So the funding came as a package for both.

HUD
introduced
GAAP + PW

Q Okay, now you suggested a firm like Price Waterhouse. Did you not, in fact, direct them to Price Waterhouse?

A I believe, if we go back over the sequence of things, Ms. Clark approached them, because I was discussing all types of work with her — not this 127 review. She knew that was out of the question because I had already, as I had in their mind at all when they were negotiating with you, isn't that correct?

A Yes.

Q All they were interested in was the A127 which they had expected to do on their own.

A Yes.

Q And they expected to do that without any help from PW or Arthur Andersen or anyone else on the face of the town, correct?

A Yes.

Q And subsequent to that and your conversations with Price Waterhouse, you then -- and if I'm using your correct terminology -- you suggested that they get a firm like Price Waterhouse to do this GAP review. And I just want to go back over that again because I want to make sure. You're saying you suggested that they get a firm like Price Waterhouse, or did you say look, why don't you talk to Price Waterhouse. And just tell me what you can remember.

A As I remember the events, the firm of Watson, Rice contacted me and said that Price Waterhouse was interested in doing some work that they knew the Department was looking to have done and were — would this be something the Department would like to have done?

Q Okay, but you had already suggested this to them. Earlier you stated you had suggested to Watson, Rice -- they didn't just come up with this.

A That's correct.

Q So — and they wouldn't have just come up with this.

A That's correct.

Q So there had to be some outside stimulus --

A That's correct.

Q -- and you were the outside stimulus.

A I wouldn't say that I started it, but, yes -- I want to clarify that as far as outside stimulus goes, this would be something that Watson, Rice, the firm, would have put into their contract at -- knowing that this is something the Department wanted to have done and it would have been an accommodation to the Department.

an accomodation

Q To your knowledge, was Watson, Rice interested in trying to develop a continuing relationship with HUD, hopefully to do some future work?

A They were very accommodating, and I can't say that — knowing that they would do future work, but with the hopes that if there was going to be any future work.

Q And you've dealt with a lot of contractors, I would imagine, before? Is that correct?

A Several major contractors.

Q And they all try to be accommodating to the Department, don't they?

A But again, you'd have to check with the GTR.

Q Okay.

A Could I go back just to clarify something?

ADMINISTRATIVE JUDGE GRESZKO: Certainly, please do.

THE WITNESS: As far as my work in the Department, there couldn't be any more work at that time for Price Waterhouse. I don't know about anybody else. I mean I didn't -- I don't represent the Department. Just so we clarify that.

BY MR. KISNER:

Q Okay, in your --

A Line of effort. Right.

Q -- your span of control.

A Right.

Q And you don't know if they were talking to anybody else in the whole Department, you just knew what they were talking to you about and you knew that they wanted more work as it related to what you had control of.

A I knew they were seeking work.

Q Okay. So in April or May or thereabouts, you asked for another work plan.

A I believe that's the question I want you to address to the GTR.

Q To the GTR?

Notice

all the decisions and negotiations, no. But I will say that after the plan was accepted, and I think about a month later, I did hear that the rates were different.

Q Now it's your testimony that you did not ask Watson, Rice to increase Price Waterhouse's involvement in the A127 review?

A That I did not ask them to increase their involvement?

Q Uh-huh.

A That's correct.

Q Do you know if anyone in the Department asked Price Waterhouse to do this -- excuse me, asked Watson, Rice to do this?

A I believe that how this happened was that when Watson, Rice got into difficulty and our Office of Procurement and Contracts sent them a letter, and the firm was negotiating with the Department how to get back on tract and to fulfill the objectives of the contract and scope of work, that several options were discussed, and the one that was agreeable to all parties, and that would be most expeditious to get this contract completed was the one where Price Waterhouse was involved.

Q Okay, now, you don't -- your testimony was you don't really know about the submissions going back and forth, and you keep telling me I need to ask the GTR, but

NV

Q Who introduced the notion of having Price Waterhouse involved in the A127?

A I don't know who introduced it. It was an option that was discussed and was discussed between my GTR and myself.

Q Okay, now, I don't mean to be picky, but this is important.

A I understand.

Q These things don't just come out of the air. I mean, where did it come from? Keep in mind that PW was not even in Watson, Rice's frame of reference from the beginning. Now, all of a sudden, you've got them playing a fairly large role in the contract, and you've stated time and again that this was discussed -- this was an option. Where did it come from?

A Price Waterhouse was their subcontractor on this job, and even though their deliverable was over, their deliverable was, I believe, delivered ahead of schedule, but again, I'd like the GTR to cite any dates on that, and because Price Waterhouse was looking at accounting principles that support the financial management systems of FHA, it -- and because they had delivered on time and they were there, and part of the original contract, it -- it -- they came into mind.

Q Whose minds did they come into?

HUD requested PW

A Department's mind.

Q So that would mean either the GTR or you?P

A I would say that it came into both our minds. That why not? This is an option too.

Q Then you all raised this as a possibility.

A Sure.

Q Okay. And what was Watson, Rice's response when you raised it? When the Department raised it?

A I believe that Alan may have made that initial presentation -- Alan Lombard, the GTR, so I think that you might want to ask him that question.

Q Isn't it a fact, though, that Watson, Rice consistently indicated that if PW was to come into the work, that it would have to have more money in their contract?

A I was not aware of that.

notification

Q Isn't it a fact that subsequent to the plan being approved -- the final plan which had the increased involvement, that notification was given to the Department that they had to have increased funds to cover those costs?

A Notification was given to me.

Q This has already been marked as Exhibit --

MR. KISNER: Your Honor, the August 28th letter?

ADMINISTRATIVE JUDGE GRESZKO: I've got August 20th, is that the same one?

MR. KISNER: No, that's not the one. Oh, here it

A The August 20th letter is in reference to the cost, the alleged cost of revised staffing resource plan, which we approved, the department approved on May 13th.

And the August 28th letter is a follow-up, a second letter, in reference to the same costs.

Q And those letters are from a member of Watson Ri staff, correct?

A Yes.

Q And the letters are seeking increased costs that they had experienced by the addition of PW staff, is that correct?

A Apportionable costs, yes, that is correct.

Q And that is what the letter says, that is what they were saying to you?

A Yes.

Q And yesterday, in your testimony, after a great deal of discussion, we concluded that the government had asked that PW be included in the A-127 work, that was your testimony yesterday, is that correct?

HUD
requested
PW

A Yes.

Q Now, in these letters, Watson Rice and Company clearly is outlining and they state in the letter, that the government's request concludes Price Waterhouse resulted in other costs being put into -- resulted in them realizing additional costs, is that correct?

A No.

Q How did your experience go with the GAP review with HUD?

A I think it went all right. We completed it in s

months and they reviewed the product and we made a few changes to it, and delivered it in the summer.

Q So, getting back to your conversation with Mr. Watson, you don't remember really how it evolved?

A Not specifically, no.

Q Do you recall a discussion between Mr. Watson and yourself, that proposed the two of your firms doing joint work, not only at HUD, but at other agencies, and any work that might come out of this A-127 review, you would do it together?

intent of
sharing
future
work

A I don't remember discussing other agencies, necessarily, but I do remember discussing if there was additional work here, the possibility and teaming together, continuing to do work here at HUD.

Q And you all agreed that you would try to put together a team for future work?

A Yes, we agreed that we would try to team together for future work.

Q And your agreement took the following form: if Watson Rice and Company secured business, they would give you a 40 percent subcontract, and if Price Waterhouse secured business, they would give a 40 percent subcontrac

A Not completely. I think we also indicated that prime would be that team that would be best suited to be t prime on it.

Q Okay, but there was a meeting of the minds that you were the prime then they would come in as a sub, and i they were suited to be the prime, then you would come in a the sub?

A Yes.

Q And the idea was that between the two firms, you would be in a more competitive position?

A Yes.

Q Now, the accounting practice in the District is extemely competitive, wouldn't you say?

A It is competitive everywhere, but it is competitive in the District, yes.

Q Okay, since we are in the District, and that is what we are talking about, we will confine our remarks to the District.

Price Waterhouse has a, would you say, has a pretty aggressive marketing program with regards to government business?

A Yes.

Q And would it be fair to say that between the two firms, Watson Rice and Company being an 8-A firm and Price

2:

A Our requirement under OMB circular A-127 is to have our financial management systems reviewed and the purpose of the contract, which is stated in the scope, w to review the A-127 financial management aspects of the system for our annual letter.

Q Okay, but that was not exactly my question.

Were you aware that the department was getting some pressure to do this?

A The only awareness that I have was that we were required to, by OMB circular A-127.

MR. KISNER: Let's go off the record for a mome

JUDGE GRESZKO: Off the record.

(Off the record.)

JUDGE GRESZKO: Back on the record.

BY MR. KISNER:

Q Were you aware that this engagement was an 8-A s aside?

A Yes.

Q Do you know why that was?

A I believe it was because of the time frame. We ha a very short time frame to get it done in.

Q And this was the quickest way to get a contract, without going through the full procurement process, is that correct?

A Yes.

swamped.

But you did get a product the first 30 days, it wasn't totally to HUD's satisfaction.

A It had to be fine tuned. There was not as much detail, it had to be more specific.

Q You wanted more detail in the plan?

A Yes.

Q Okay, go ahead.

A Okay.

And then the plan we got in November, we had a management plan. In other words, it is called the Pert Chart, where we had each one of the reviews, or subcomponents of the A-127 review, which outlined due dates when each individual products were going to be delivered that they had developed in their own schedule in the review plan, with the staff that they had assigned to it. Those were the details that they had to provide for the November plan.

Q Okay, now, this A-127 work, this was the first time that this was to be done in the department?

A Yes.

Q So it was a new process. There were not really any guidelines or standards that HUD could draw on because it had never been done before?

A Well, the answer to that is no, because in the contract we put in the criteria that we had, we had the O circular criteria; we had the OMB more detailed explanati of how to do things and the presentation that I went to i August, Watson Rice and Company presented the information that they were finishing up on an A-127 review in -- I believe it was the Department of the Navy. So, that would be the expertise.

It was a new process, Watson Rice and Company ha done it once before and we were hoping to utilize their experience.

Q Okay, just for the record, I believe it was an A-123 that they had done at the Navy, not an A-127. Because there really had not been any A-127's done.

A Are you --

MR. GRANT: I really don't care for how he answered the question, but it really was not -- he was giving some sort of a statement, but he has answered the question once and he wants to clarify it, if counsel wants to clarify it, he should ask a question.

JUDGE GRESZKO: That is correct. Your objection is sustained, although you can reask that question, resubmit that question in terms of prior testimony to see if it has a refreshing effect on the witness.

MR. KISNER: You can strike the question.

A It is a management services approach for CPA purposes.

scope questioned internally @ HUD

Q Okay, and there was some question about that, a the time, the work was being done, wasn't there?

A Oh, yes.

Q And because of the question, would you say that that contributed to some of the problems that Watson Rice and Company encountered?

A No.

Q So, because of the questions, what happened in your mind?

A The question in our mind, I don't remember who w raised this with, but the question was raised, you have different requirements for doing an audit and a financial management review. Because it is an A-127 review, we couldn't use the criteria that is published by the AICPA f an audit, we had to use the criteria for a management services contract. And it is one of the issues that we discussed early on.

Q Now, isn't that the position that Watson Rice and Company had taken? That was not the department's original position, was it?

A All right, I don't remember there being a disagreement on that.

submitted by any 8-A firm?

A No.

Q So there wouldn't be any difference in terms of your usefulness of the report?

A No.

Q Would you say that there is a -- now, --

A I was just going to say that we were looking toward an independent third party viewpoint.

Q Okay. You are a CPA, so that you are familiar with what a Big Eight firm is?

A Yes.

Q Is there a certain amount of prestige attached to a Big Eight firm?

A Yes.

Q And reports or audits that have their, have a Big Eight firm's name attached to it, are they given more weight?

A They are not given more weight by me.

Q I don't mean by you.

A Well, I can't answer for other people.

Value

Q Well, just in the profession?

A It is more prestigious.

Q All right.

Now, you found the report acceptable, is that correct?

A Yes.

accepted final report

Q And you signed off on the report and, in fact, y released the retainage that would have been held back, if there had been something wrong, is that correct?

A Yes.

Q What is that, can you just tell us, what this means, this retainage, what is that used for?

A In my mind, the retainage is your -- all right, i my mind, as the government's technical representative, - because also the contract officer also had to sign off on it, too, obviously -- I signed off on it when -- we have go one final report, and two, the work papers.

Q And they had to be acceptable or you wouldn't hav signed off to allow the retainage to be released, correct?

A Not the work papers. The work papers were subject to post-audit.

Q But the report had to be acceptable?

A Yes.

Q And the last exhibit I have marked is 13, so that we are actually at 14. It is 11, 12, and 13, so that we are at 14.

MR. KISNER: Can we go off the record?

JUDGE GRESZKO: Sure, off the record.

(Off the record.)

JUDGE GRESZKO: Back on the record.

Q The May 8th letter, which we have marked as Exhibit A-12 came before what we have marked as Exhibit 13, which was dated May 12th, is that correct?

A I can't answer unless I go back and look at my files, because I date these things when I receive them.

Q All right.

A It would appear logical but I can't state that.

Q Okay, but it would appear logical that that is what happened?

A Yes.

Q Okay, if we take your logical determination, jus for discussion here, there is a difference in these two plans, is that correct?

A Yes.

Q And the difference has to do with the level of Price Waterhouse involvement, is that correct?

A Yes.

MR. KISNER: Excuse me, one minute, Your Honor.

(Pause.)

BY MR. KISNER:

Q Directing your attention to the two staffing resource allocation plans, of the first letter which logically you said would have come before the second one, can you tell us what the differences are in the staffing plans?

only difference
is shift of
Partner &
manager
hours fr
WRC to PW

A I think -- well, right off the top, we have -- there is a reduction in the number of the Watson Rice and Company people and there is an increase in the number of Price Waterhouse people.

Q And that had to have been as a direct result of the questions that you raised in your letter of May 7th, or whatever it is, whatever date?

A Yes, that relates to the quality of the staff assigned to do the work.

Q So, the final plan that was accepted had an increased level of Price Waterhouse personnel?

A Yes.

Q Now, Watson Rice and Company raised the issue that this would cost them more money, didn't they?

A At that time, no.

Q What do you mean, at that time?

A At that time, no. At a subsequent time, the issue of additional costs was raised. At those meetings, we were discussing staff utilizations and staff resources. In July, when we got the first full invoice with the increased staffing levels, I did a projection on the costs, and informed the project manager, who is Alonzo Cockrell, that the way their costs were going, they were going to exceed their fixed price in the contract.

Q Okay.

A They have just started -- I know what you are getting to now. They just started some type of financial review of the government accounts of some sort. I am not sure exactly what it is. I am not the government tech representative on that contract.

Q Are you GTR on any of the ones that they are doi right now?

A No.

MR. GRANT: I am going to object as to relevance, in that I don't follow this line of questioning myself.

JUDGE GRESZKO: Where are you trying to go with it?

MR. KISNER: Well, we have made the allegation earlier and we will make it later on also, that Watson Rice and Company was willing to take Price Waterhouse on with the idea that they would be doing future work. That, in fact, and we have heard testimony that the two were going to try to put together a team. That any other work that came out of this current contract, the two of them would work together. I am trying to show that this didn't happen.

Price Waterhouse is doing work that directly came out of this engagement that is the subject of the hearing.

JUDGE GRESZKO: How does that relate back to the Watson Rice and Company claim for extra costs incurred?

MR. KISNER: Well, it goes to the issue of what think why Watson Rice and Company did not object to bring them in; why they may not have received the written requirement that the statute says for a change; and why th accepted certain representations that were made.

It goes to setting, kind of the framework, and t environment in which they made these decisions that one might say, well, why would you make that decision without written documentation?

JUDGE GRESZKO: I will let you proceed on that basis.

BY MR. KISNER:

Q Now, you stated that you felt that they were doin an A-123 review, is that correct?

A Would you repeat the question?

Q You -- I am just rephrasing what you said.

You said that you thought they were doing an A-12 review.

A They being?

Q Price Waterhouse, yes.

A Okay.

Price Waterhouse currently has three or four people, staff members, doing A-123 reviews as a subcontractor to Grant Thornton.

And then after the contract, we had several meetings in O management and with Roosevelt Jones about the claim he ha raised.

Q Did you know of a plan to try to get the money o of FHA to pay them?

A No.

Q Okay. Is Price Waterhouse still doing work for the department, to your knowledge?

PW still working

A Price Waterhouse is currently a subcontractor on contract with Grant Thornton. They currently have the contract with GAO to do some type of financial audit.

Q For HUD?

A GAO is paying for it, and Price Waterhouse is doing the audit of HUD. I think it is under the Corporatic Control Act.

Q Now, the work with Grant Thornton, would you characterize that work as an outgrowth of the A-127 review work that they were involved in?

A No.

Q It is totally different?

A Yes.

Q Can you tell us what it is, exactly, that they are doing?

A On the Price Waterhouse contract, subcontract to Grant Thornton, they are doing an A-123 reviews right now.

Q Now, isn't it a fact, that that is exactly wha they did or very similar to what they did with the GAAP review under the subcontract with Watson Rice and Compan

A The answer to your question is, the A-127 revie are done in accordance with OMB circular A-127. And the 123 reviews are done in accordance with OMB circular A-12 It does require the same type of personnel and there is a advantage to having people that are experienced in HUD, b they are not the same things.

Q But they are related though, aren't they?

A Yes, as almost any other audit work.

reference to A-123 & A-127 as "audit work" shows ~~they~~ he still holds view that A-127 is audit -- not consulting engagement

Q Do you know whether or not Watson Rice and Compa and Price Waterhouse submitted a bid for that work?

A I believe they did.

Q And do you know what happened?

A What happened to the bid?

Q Yes.

A Secondhand knowledge is that they delivered the bid late. They missed the cutoff date.

Q That is Watson Rice and Company and Price Waterhouse missed the cutoff date?

A Yes. This is all secondhand, because anybody that missed the cutoff date, we would have never have seen the documentation.

Q And do you know how Price Waterhouse ended up becoming a subcontractor with Grant Thornton to do this w

MR. GRANT: Objection, again, as to relevance.

MR. KISNER: It is the same line. I mean, we h already heard him say that Price Waterhouse and Watson Ric and Company missed the bid date for this very work that th are now doing, only they are doing it with Grant Thornton, as opposed to Watson Rice and Company.

MR. GRANT: Well, presumably they got the bid.

MR. KISNER: Well, that is what I am trying to ask, did they bid it together? And as the GTR, he would know.

THE WITNESS: I am not the GTR on the current contract.

MR. KISNER: Okay.

BY MR. KISNER:

Q But would you have a way to know whether or not it was bid together by Grant Thornton and Price Waterhouse?

A The answer would be yes.

Q They bid it together?

A Yes.

Q Okay.

MR. KISNER: All right, Your Honor. I have no further questions.

JUDGE GRESZKO: Cross-examination, Mr. Grant?

Same K that
PW/WRC missed
when PW delivered
proposal late

PW bid
w/ GT after
dropping
WRC ? !?

MR. GRANT: Just a couple of things.

Thank you, Your Honor.

CROSS-EXAMINATION

BY MR. GRANT:

Q Mr. Lombard, you testified that you wrote, you prepared the statement of work that became a part of the contract?

A Yes, sir.

Q The basic contract. And in that contract, or I a sorry, in the statement of work, you included and wrote in the scope of the --

A Yes, sir, it is on the first page.

MR. GRANT: I don't have any further questions. thought I had some questions.

JUDGE GRESZKO: Any redirect?

MR. KISNER: Just one last one.

REDIRECT EXAMINATION

BY MR. KISNER:

Q You did, the department received what they paid for? I mean they got the final report submitted by Price Waterhouse and Watson Rice and Company?

A Yes, sir, they prepared and I signed invoices.

HUD
received
Value

Q The government got what they paid for?

A All I can say is that my role, as GTR, we got the product we asked for.